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Car Wars: Valuation Standards in Chapter 13 Bankruptcy Cases

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Articles

CAR WARS: VALUATION STANDARDS IN CHAPTER 13 BANKRUPTCY CASES

by
*David Gray Carlson**

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I. INTRODUCTION

Bankruptcy reorganization is premised on the existence of a surplus beyond the amount realizable in a liquidation,¹ but who owns this surplus?

In part, ownership of the surplus is established by the standard of valuation applied to collateral claimed by the secured creditors.² In all the reorganization chapters, the secured creditors must receive the present value of their collateral.³ The competing parties take the leftovers. This division of the surplus is what is promised by the notion of "cram down"—the unpleasant force-feeding metaphor⁴ that refers to the minimum entitlements creditors must get if they vote "no" on a reorganization plan.

If a bankruptcy court assigns a liquidation value to the collateral of secured creditors, it thereby awards the surplus to the unsecured creditors or to the debtor. Liquidation value is usually taken to imply what the creditor could realize in a forced sale under the rules of UCC Article 9 or real estate mortgage provisions or (even worse) under the rules of judicial execution. Such sales are notoriously poor in producing cash proceeds.⁵ If hypothetical liquidation is the standard, a court could easily justify a rather lowball figure by way of value.⁶

In chapter 11, going concern value has been used in two senses. First, it might represent what a third party would pay for an entire business.⁷ Alternatively, it might represent the present value of fu-

¹ See 11 U.S.C. §§ 1129(a)(7), 1225(a)(4), 1225(a)(5), 1325(a)(4), 1325(a)(5) (1994).

² See Isaac Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N. CAR. L. REV. 925, 958 (1980) ("The philosophical question implicit in the battle over valuation methods in this situation is whether the secured creditor is entitled to a portion of the going concern bonus inherent in its collateral.").

³ See 11 U.S.C. §§ 1129(b)(1), 1225(a)(5), 1325(a)(5) (1994).

⁴ Even worse, some cram downs in farm reorganizations (chapter 12) are known as "eat dirt" plans, where the farm is conveyed to the mortgagee in satisfaction of antecedent debt. *First Brandon Nat'l Bank v. Kerwin-White*, 109 B.R. 626, 630 n. 3 (Bankr. D. Vt. 1990) (Billings, J.) (asset payment chapter 12 plan); see also *In re Kerwin-White*, 129 B.R. 375, 378 n. 9 (Bankr. D. Vt. 1991) (Conrad, J.) (justifying "eat dirt" plan when secured party claims unsecured deficit after asset payment).

⁵ See generally *In re Robbins*, 119 B.R. 1 (Bankr. D. Mass. 1990) (Queenan, J.) (declaring that liquidation value would be 87% of "fair market value").

⁶ See *In re Ralar Distribs., Inc.*, 166 B.R. 3, 8-9 (Bankr. D. Mass. 1994) (Queenan, J.) (secured party would have realized less than the debtor's actual bulk sales), *aff'd*, 182 B.R. 81 (D. Mass. 1995), *aff'd*, 69 F.3d 1200 (1st Cir. 1995).

⁷ See *In re T.H.B. Corp.*, 85 B.R. 192, 195 (Bankr. D. Mass. 1988) (Queenan, J.) (identifying liquidation value as the sum obtainable by a bank if it foreclosed on a business and

ture sales of inventory in the ordinary course of business.⁸ Either way, going concern value is usually thought to exceed liquidation value.⁹ When chapters 12 (farm reorganizations) or chapter 13 (wage earner plans) are at stake, the phrase "going concern value" seems inappropriate, because these plans involve individuals contributing labor to make the plan work. Instead, the courts substitute replacement or retail value for going concern value. In addition, "wholesale value" replaces "liquidation value," in this discourse—on the assumption a secured party would "liquidate" collateral in the wholesale market.¹⁰

The prodigal weight of authority in chapter 11 cases favors go-

sold the assets in a piecemeal manner, as opposed to the value the bank could obtain if it sold the business as a going concern).

⁸ See *In re Kids Stop of America, Inc.*, 64 B.R. 397, 401-02 (Bankr. M.D. Fla. 1986) (Paskay, J.) (equating going concern value equated with retail value of inventory in the debtor's business); Owen W. Katz, *Valuation of Secured Claims in a Bankruptcy Reorganization: Eating with the Hounds and Running With the Hares*, 100 COM. L.J. 320, 324 (1995). Going concern value might still be used even if it is decided that *no one* would buy the property in question. One approach substitutes *investors* for buyers and then hypothesizes a value without a sale. Rather, an investment in the firm is hypothesized. This is called the "investment value approach." *In re Raylin Dev. Co.*, 110 B.R. 259, 260 (Bankr. W.D. Tex. 1989) (Clark, J.). Such an approach can capture the value of an income producing asset even if no buyers of the asset are thought to exist.

⁹ It is sometimes argued that secured parties ought to get a going concern value that is *lower* than liquidation value, because the debtor is an incompetent manager or irrational economic actor. This version of going concern value assumes, of course, that the debtor would continue to be in operation. Courts reject this argument and insist that the property be valued according to its *best* use, not the suboptimal use that currently exists. See *In re Sherman*, 157 B.R. 987, 990 (Bankr. E.D. Tex. 1993) (Sharp, J.); *In re Stockbridge Props. I, Ltd.*, 141 B.R. 469, 472 (Bankr. N.D. Ga. 1992) (Cotton, J.); *In re Peerman*, 109 B.R. 718, 722 (Bankr. W.D. Tex. 1989) (Monroe, J.); *In re Ehrich*, 109 B.R. 390, 391 (Bankr. D.S.D. 1989) (Hoyt, J.). In *Peerman*, it was the *secured party* who argued for the low value. This may seem as irrational as the debtor's behavior is alleged to be, but not so. The case involved "asset payment"—transfer of the collateral in satisfaction of antecedent debt. The lower the value, the higher the secured party's remaining deficit claim would have been in bankruptcy. Meanwhile, if the valuation turned out to be too low, so much the better for the secured party who could later sell the collateral for the higher "correct" price and keep all the profits.

But see *Brace v. United States (In re Brace)*, 163 B.R. 274, 277-78 (Bankr. W.D. Pa. 1994) (Bentz, J.) (using the value of a working farm, not the higher value of the property as a "hobby" farm for wealthy dude ranchers).

¹⁰ *But see* *Taffi v. United States (In re Taffi)*, 68 F.3d 306 (9th Cir. 1995), *aff'd en banc*, 96 F.3d 1192 (9th Cir. 1996). In attempting to escape the force of *General Motors Acceptance Corp. v. Mitchell (In re Mitchell)*, 954 F.2d 557 (9th Cir.) (Schroeder, J.), which held for wholesale valuation of cars in chapter 13, Judge Clifford Wallace ruled that "fair market value" is not the same as retail value, nor is "forced sale" value to be equated with wholesale value. Rather, the reorganization value might be retail or wholesale. *Taffi*, 68 F.3d at 308-09. Judge Alex Kozinski dissented, claiming that the parallel denied by Judge Wallace was exact. *Id.* at 310 (Kozinski, J., dissenting).

ing concern value, so that secured creditors share in the surplus. This standard might be viewed as largely settled.¹¹ But in chapter 13 cases, courts are divided over the relevant valuation standard.¹²

Chapter 13 cases involve individuals with regular income and modest debt.¹³ A surplus exists in these cases by virtue of the debtor's dedication of postpetition wages to the community of creditors.¹⁴ In chapter 7 liquidations, these postpetition wages would belong to the debtor alone.¹⁵ In chapter 13, the debtor may, in effect, buy back all of her property by dedicating future wages to the creditors in excess of the property's liquidation value.

For causation reasons, the valuation theory in chapter 13 has been more unsettled than it has been in chapter 11 cases. In chapter 11, it is often easy to envision collateral as *causing* the chapter 11 surplus. For example, if the debtor is a retail operation, encumbered inventory plays a clear role in creating the surplus. In chapter 13, however, the causal intuition is less clear. As recently put by the Fifth Circuit Court of Appeals: how does the encumbered recliner upon which a weary debtor rests by night cause the surplus in question?¹⁶

Although the causal intuition is weaker in chapter 13, the trend nevertheless favors going concern valuation, which enriches the secured creditors. Thus, the Ninth Circuit, which initially favored a

¹¹ A lonely voice of dissent has been Judge James Queenan, who holds out for liquidation valuations for encumbered assets. See, e.g., *In re Robbins*, 119 B.R. 1, 3-4 (Bankr. D. Mass. 1990). This view may have been overruled in the First Circuit by *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Savings (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 74 (1st Cir. 1995) (Stahl, J.). But, confusingly, Judge Norman Stahl subsequently upheld Judge Queenan's use of a liquidation value in *Baybank-Middlesex v. Ralar Distributors, Inc.*, 69 F.3d 1200 (1st Cir. 1995). The issue in *Ralar Distributors* was whether the secured party was entitled to §506(b) postpetition interest. Judge Queenan had held that, in light of mere liquidation value, the secured party had no such entitlement. See *id.* at 1202-03. Hence, the two most recent First Circuit precedents are in contradiction.

Just before this article went to press, the Seventh Circuit decided that the average between wholesale value and replacement value of collateral should be used. *In re Hoskins*, 1996 U.S. App. LEXIS 32663 (7th Cir. Dec. 12, 1996). Although it was a chapter 13 case, Judge Richard Posner expressly indicated that the standard was also appropriate for chapter 11. *Hoskins* therefore probably overrules *In re 203 N. LaSalle Street Ltd. Partnership*, 190 B.R. 567, 578 (Bankr. N.D. Ill. 1995), *aff'd*, 195 B.R. 692 (N.D. Ill. 1996), where Judge Eugene Wedoff joined Judge Queenan in favoring liquidation value for chapter 11 cases.

¹² See *infra* notes 17-23 and accompanying text.

¹³ See 11 U.S.C. § 109(e) (1994).

¹⁴ See 11 U.S.C. §§ 1306(a)(2), 1322(a)(1), 1325(a)(4) (1994).

¹⁵ See 11 U.S.C. § 541(a)(6) (1994).

¹⁶ See *Associates Commercial Corp. v. Rash (In re Rash)*, 90 F.3d 1036, 1052 n.21. (5th Cir. 1996) (King, J.) (en banc).

liquidation value,¹⁷ has recently reversed itself *en banc*.¹⁸ The Fifth Circuit, however, travels in the opposite direction. After a three-judge panel opted for going concern valuations in chapter 13 cases,¹⁹ an *en banc* panel reversed in favor of liquidation (*i.e.*, wholesale) value.²⁰ This is so even though other Fifth Circuit precedent points to going concern valuations in chapter 11.²¹ Hence, the Fifth and Ninth Circuits are now embanked against each other on this important question. Meanwhile, the Eighth Circuit²² and perhaps the First Circuit²³ favor going concern valuations. In the waning days before this article went to press, the Seventh Circuit decided for the *average* between going concern and liquidation values—thereby increasing even more the unseemingly division amongst the circuits.²⁴

In chapter 13, the battle is usually fought over cars.²⁵ The used car industry is well mobilized on the valuation front. The National Automobile Dealers Association (NADA) has produced a manual of wholesale and retail prices for all makes and models of cars. From the perspective of a bankruptcy judge, it is easy to refer to this manual to find the appropriate value of the car,²⁶ though this must always be supplemented by evidence of the actual condition of the car. But shall the judge choose the listed wholesale (*i.e.*, liquidation) or the retail (*i.e.*, going concern) valuation?

The Bankruptcy Code²⁷ is very opaque on this question. Valua-

¹⁷ See *General Motors Acceptance Corp. v. Mitchell* (*In re Mitchell*), 954 F.2d 557 (9th Cir.) (Schroeder, J.).

¹⁸ *Taffi v. United States* (*In re Taffi*), 96 F.3d 1190 (9th Cir. 1996) (Noonan, J.) (*en banc*).

¹⁹ *Associates Commercial Corp. v. Rash* (*In re Rash*), 31 F.3d 325 (5th Cir. 1994) (Smith, J.), *modified*, 62 F.3d 685 (5th Cir. 1995), *rev'd*, 90 F.3d 1036 (5th Cir. 1996) (*en banc*).

²⁰ *Rash*, 90 F.3d at 1043-51.

²¹ *United Savs. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.* (*In re Timbers of Inwood Forest Assocs., Ltd.*), 808 F.2d 363, 373 (5th Cir. 1987) (King, J.) (*en banc*), *aff'd*, 484 U.S. 365 (1988).

²² See *Metrobank v. Trimble* (*In re Trimble*), 50 F.3d 530, 532 (8th Cir. 1995) (Ross, J.).

²³ See *supra* note 11.

²⁴ *In re Hoskins*, 1996 U.S. App. LEXIS 32663 (7th Cir. Dec. 12, 1996) (Posner, J.).

²⁵ Homes are largely not in dispute, because chapter 13 debtors are permitted to cure and reinstate but not to otherwise modify the rights of long term mortgagees. See 11 U.S.C. §§ 1322(b)(2), 1322(b)(5) (1994). They are, however, permitted to modify the rights of lenders who finance cars.

²⁶ See *Associates Commercial Corp. v. Rash* (*In re Rash*), 149 B.R. 430, 431 (Bankr. E.D. Tex. 1993) (Sharp, J.), *rev'd*, 31 F.3d 325, 330 (5th Cir. 1994) (Smith, J.), *modified*, 62 F.3d 685 (5th Cir. 1995), *rev'd en banc*, 90 F.3d 1036 (5th Cir. 1996).

²⁷ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-1330), as amended by Bankruptcy Amendments and Federal Judgeship Act of

tion is usually thought to be governed, if at all, by Bankruptcy Code § 506(a), which provides:

[1] An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.

[2] Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.²⁸

Often, the question of valuation standard is said to turn on which of the two numbered sentences from § 506(a) predominates over the other. Those favoring liquidation value privilege the first sentence, because it supposedly bids a court to consider what a creditor would obtain in a foreclosure sale under state law. Those favoring going concern valuations favor the second sentence which admonishes courts to consider the "proposed disposition or use" of the collateral.

Although it is probably impossible to answer this question from § 506(a) alone, a very close examination of the Bankruptcy Code, with special attention to a "holistic" reading²⁹ of its myriad sections,

1984, Pub. L. No. 98-353, 98 Stat. 333 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3114 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended in various sections of 11 U.S.C.); Omnibus Budget Reconciliation Act of 1990, Pub. L. No. 101-508, 104 Stat. 1388 (codified as amended in various sections of 11 U.S.C.); Criminal Victims Protection Act of 1990, Pub. L. No. 101-581, 104 Stat. 2865 (codified as amended in various sections of 11 U.S.C.); Crime Control Act of 1990, Pub. L. No. 101-647, 104 Stat. 4789 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Judicial Improvements Act of 1990, Pub. L. No. 101-650, 104 Stat. 5089 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Treasury, Postal Service and General Government Appropriations Act of 1990, Pub. L. No. 101-509, 104 Stat. 1389 (codified as amended in various sections of 28 U.S.C.); Department of Commerce, Justice, and State, the Judiciary, and Related Agencies Appropriations Act of 1994, Pub. L. No. 103-121, 107 Stat. 1153 (codified as amended in various sections of 28 U.S.C.); Violent Crime Control and Law Enforcement Act of 1994, Pub. L. No. 103-322, § 320934, 108 Stat. 1967, 2135 (1994); and Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 3146 (codified in various sections of 11 U.S.C., 18 U.S.C., and 28 U.S.C.) [hereinafter Bankruptcy Code or Code].

²⁸ 11 U.S.C. § 506(a) (1994).

²⁹ Speaking of secured claims, Justice Antonin Scalia has directed courts to read the

points, if only faintly, toward liquidation value—in derogation of the vast weight of authority in chapter 11 cases and in spite of the arguable trend in chapter 13 cases in the same direction. The Bankruptcy Code should be read as favoring liquidation or wholesale value of collateral, on the theory that secured creditors, in the absence of bankruptcy, would tend to get this price in disposing of the collateral in a foreclosure situation. This standard, however, might be superseded where a secured party could demonstrate by convincing evidence that the secured creditor in question has the ability to obtain some other value upon foreclosure—evidence that should emphasize the secured creditor's historical record in actually doing so.³⁰

But more fundamentally, the distinction between wholesale and retail prices is a false one. Retail prices reflect value added by the retailer. If the cost of value added by the retailer were to be removed from retail value, the remainder would be wholesale value. Hence, wholesale is simply retail minus the transaction costs of retailing. As will be shown, these transaction costs ought to be removed.

This article will attempt to prove that appellate courts should not even try to legislate a choice between wholesale and retail value. Instead, valuations should be viewed as a question of fact, consigned to the discretion of the fact finder. Meanwhile, techniques of valuation will tend to collapse the distinction between wholesale and retail value. In short, wholesale is the key to valuations in the bankruptcy context.

Part II provides some philosophical background to the question of valuation. In particular, it will be emphasized that a cost-benefit

Bankruptcy Code holistically:

Statutory construction . . . is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear, or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law. That is the case here. Section 362(d)(1) is only one of a series of provisions in the Bankruptcy Code dealing with the rights of secured creditors. The language in those other provisions, and the substantive dispositions that they effect, persuade us that the “interest in property” protected by section 362(d)(1) does not include a secured party's right to immediate foreclosure.

United Savs. Ass'n v. Timbers of Inwood Forest Assocs., Ltd., 484 U.S. 365, 371 (1988) (Scalia, J.); *cf. Dewsnup v. Timm*, 502 U.S. 410, 422 (1992) (Blackmun, J.) (adopting antiholistic definition of “secured claim,” as that term is used in § 506(d)).

³⁰ *But see In re Waters*, 122 B.R. 298, 301 (Bankr. W.D. Tex. 1990) (Clark, J.) (refusing to hear evidence in favor of wholesale value in a redemption case).

analysis of given valuation standards is profitless, because our economy is too complex to predict with confidence the consequences of choosing one standard over another. Various fairness arguments will be examined, but found to be contestable. Ultimately, it will be shown that the discussion of the proper valuation is what this Article will call a *subjunctive* one, based on visions of propriety that cannot be proved empirically or logically.³¹ Although these competing visions are coherent and rhetorically forceful, no one vision has leverage enough to eliminate its competitors. Hence, mere subjunctive speculation cannot determine ownership of the bankruptcy reorganization surplus. For this reason, valuation must be a question of fact, not of law.

Part III proceeds to examine the text of the Bankruptcy Code for evidence of a solution and argues that the text of § 506(a) does not settle the valuation standard. A landmark Supreme Court case examines the text of § 506(a) for another purpose—whether undersecured parties are entitled to protection of the *value* of their secured claims with postpetition interest. In *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*,³² the Supreme Court held that undersecured creditors were *not* entitled to postpetition interest. Courts have tried to deduce answers to the valuation question from the text of this extremely important decision. This Article will show that these attempts are inconclusive. Nor is there a logical connection between the practice of deducting hypothetical transaction costs from a given value. That is, a court may have a rule whether valuations are *ex ante* or *ex post* transaction costs, but this practice, whatever it is, does not shed light on the proper valuation standard that should be used in the first place.

That which pushes the Bankruptcy Code toward liquidation values in reorganization cases is discussed in the last two sections of Part III. First, all reorganization chapters require that *unsecured* creditors obtain what would have been received in a hypothetical liquidation. This, it will be argued, infects cram down and implies that cram down valuations should be on the basis of liquidation value. Second, cram down itself implies liquidation value. In the case of dissenting creditors, a debtor may cram down a plan either by abandoning the collateral to the secured party (so that a foreclosure sale

³¹ On valuation's subjunctive soul, see David Gray Carlson, *Secured Creditors and the Eely Character of Valuations in Bankruptcy*, 41 AM. U. L. REV. 63, 70-75 (1991).

³² 484 U.S. 365 (1988) (Scalia, J.).

can occur under state law), or by retaining the collateral but distributing legal rights with a comparable value to the secured creditor. These two cram down options should be the same, from the perspective of the secured creditor. Since abandonment implies liquidation under state law procedures, cram down through retention and valuation should likewise be on the basis of liquidation values (pending the secured creditor's proof of access to retail markets). This will be defended as the "holistic" meaning of the Bankruptcy Code.

II. THE CHAPTER 13 SURPLUS

The premise of bankruptcy reorganization is the creation of a surplus over what might have been achieved in chapter 7 liquidation. The cause of the surplus will vary between chapters 11, 12 and 13.³³ In chapter 11, the surplus is economically created. In some cases, it might result from informational advantages of existing management. In others it comes from sunk costs of arranging piecemeal assets in a strategic position.

In chapter 13, the surplus is purely the product of a legal rule that exempts wages from the bankruptcy estate in chapter 7. In chapter 7, a debtor loses all nonexempt property to the creditors, but retains all postpetition earnings.³⁴ In chapter 13, the debtor buys back the property with wages.

A debtor cannot be forced into chapter 13 against her will.³⁵ Since the chapter 13 plan must be financed by wages, there is no good way for legislation to commit the debtor to fund the plan through wages. Any such attempt flirts with involuntary servitude.³⁶

The debtor pondering a chapter 13 proceeding must therefore make a cost-benefit analysis, compared to the alternatives. If we say that chapter 7 liquidation is the alternative, then the debtor must weigh the value of an increased discharge of debt³⁷ and retention

³³ Chapter 12 governs farmer reorganizations. The text of chapter 12 very closely matches the text of chapter 13. For convenience, only chapter 13 will be referred to with the understanding that what is said also applies to chapter 12 reorganizations. On the rare occasion when chapter 12 diverges from chapter 13, suitable warning will be provided.

³⁴ See 11 U.S.C. § 541(a)(6) (1994).

³⁵ See 11 U.S.C. § 303(a) (1994).

³⁶ See Karen Gross, *The Debtor as Peon: A Problem of Unconstitutional Conditions*, 65 NOTRE DAME L. REV. 165 (1990).

³⁷ See 11 U.S.C. § 1328(a)(1) (1994).

of all assets³⁸ against the wages that must be given up—that is, all disposable income for the life of the plan.³⁹

Once the debtor opts for chapter 13, a surplus must be created by the debtor from postpetition wages. Of course, a self-interested debtor would wish to contribute the fewest wages possible and still have a confirmable plan. According to the provisions of chapter 13, the debtor must pay in enough wages to make sure that all priority creditors are paid (including administrative, family support, and taxes),⁴⁰ all unsecured creditors at least obtain the present value of what they would receive in a hypothetical liquidation,⁴¹ and all secured creditors receive the present value of their collateral.⁴² Once these constraints are honored, the plan may end, and the debtor may cease paying in wages.

Two additional rules constrain the debtor, however. First, the plan cannot endure past three years or, for cause and with court permission, five years.⁴³ Second, during the plan's duration, a debtor must contribute all of her "disposable income."⁴⁴

Valuation of the collateral determines how much the debtor must pay to satisfy the "cram down" obligation to the secured creditor. A "liquidation" valuation benefits the debtor compared to a going concern (*i.e.*, retail or replacement) value.⁴⁵

It has been suggested that, in chapter 13 cases, the debtor is usually indifferent to the valuation standard for encumbered assets. The dissenting opinion in *Associates Commercial Corp. v. Rash (In re Rash)*, claimed that, typically, the debtor is unconcerned with the valuation standard of collateral, because the debtor must in any case surrender all disposable income and therefore cannot pocket the savings.⁴⁶

³⁸ See 11 U.S.C. § 1306(b) (1994).

³⁹ See 11 U.S.C. § 1325(b)(1)(B) (1994).

⁴⁰ See 11 U.S.C. § 1322(a)(2) (1994).

⁴¹ See 11 U.S.C. § 1325(a)(4) (1994).

⁴² See 11 U.S.C. § 1325(a)(5) (1994).

⁴³ See 11 U.S.C. § 1322(d) (1994).

⁴⁴ 11 U.S.C. § 1325(c) (1994).

⁴⁵ *In re Hoskins*, 1996 U.S. App. LEXIS 32663, 29-30 (7th Cir. Dec. 12, 1996) (Easterbrook, J., concurring). Retail or replacement value are both designed to represent valuation from the perspective of the debtor's subjective estimate of the collateral's worth. See *Taffi v. United States (In re Taffi)*, 68 F.3d 306, 310 (9th Cir. 1995) (Kozinski, J., dissenting) (retail value means "the value of the car in the hands of the debtor"), *aff'd en banc*, 96 F.3d 1190 (9th Cir. 1996).

⁴⁶ 90 F.3d 1036 (5th Cir. 1996) (Smith, J., dissenting) The majority disagreed, reasoning

It may well be true that the valuation question will push few chapter 13 cases beyond the realm of confirmability, but it is not the case that the debtor is otherwise indifferent to the question. Unsecured creditors are not guaranteed to get what is withheld from the secured creditors. Indeed, both the *Rash* court majority and dissent overlook the fact that the debtor *can* pocket disposable income simply by shortening the duration of the plan.⁴⁷

Still, even under replacement valuation, chapter 13 plans can be feasible and profitable, compared to liquidation. They are, however, more expensive for debtors, who must extend the plan until disposable income suffices to cover the higher valued secured claim. Only at the margin will higher valuations make chapter 13 plans impossible, as a court may not extend the plan beyond five years of disposable income.⁴⁸ Thus, the question of valuation devolves into this: how much of a fresh start do chapter 13 debtors deserve?

A. *Ethics and Intuition*

The surplus in a chapter 13 plan must be divided up between the secured creditors, the unsecured creditors, and the debtor. By what ethical theory might this allocation be achieved?

According to the precepts of law-and-economics—surely the dominant rhetoric of ethical discourse in the law schools, for better or worse—ownership of the surplus would be derived in a way that would maximize the wealth, not of any given owners of a surplus, but of the world in general. Between specific debtors and creditors (who are not “repeat players”), division of the surplus has no effect on the aggregate amount of wealth. Rather, the division is only distributional and hence of no concern to law-and-economics theorists. But creditors, at least,⁴⁹ *are* repeat players. If it could be shown

that determination of the amount of the secured claim “may be the critical difference in whether the debtor’s plan is confirmed.” *Id.* at 1055 n.25.

⁴⁷ Under the common law of chapter 13, judges may declare chapter 13 plans in bad faith when they end too soon to please the court’s sense of justice. *See In re San Miguel*, 40 B.R. 481, 483 (Bankr. D. Colo. 1984) (Gueck, J.). Good faith is a requirement for confirmation of the plan. *See* 11 U.S.C. § 1325(a)(3) (1994).

⁴⁸ The *Rash* case seems to have been one of these marginal cases. *See Rash*, 90 F.3d at 1055 n.24 (plan for five years’ payment could not have paid secured creditors and priority creditors if replacement value were to be adopted). Judge King denied the rareness of the case and saw the one before her court as one in which valuation was outcome-determinative. *See id.* at 1055 n.25.

⁴⁹ And perhaps many debtors.

that one set of property rules induces socially optimal behavior in comparison to another set, and if it is agreed that maximizing utility or wealth⁵⁰ is the one and only value at stake in the legislation, then property entitlements could be deduced from wealth maximization criteria.

Unfortunately, efficiency of an important legal institution is not a verifiable proposition in the world. Consider that the efficiency consequences of any given contract is an empirical question—not an *a priori* truth. Contract is efficient only if rational parties exchange commodities in *perfect* markets. Yet the criteria for perfect markets are so metaphysically impossible⁵¹ that contract is not *a priori* efficient, but only contingently so. Every contract produces external costs and benefits. Unless all of these externalities are quantified all at once throughout all the world, we cannot know whether a single contract exchange is efficient. If a simple contract exchange carries such a burden, how much less so could an entire set of legal rules be assessed for their effect on human happiness in the world?

A rule that awards entitlements to secured creditors against unsecured creditors produces a flood tide of external costs and benefits. If secured creditors receive more of a reorganization surplus, then unsecured creditors receive less. This adjustment in distribution changes demand throughout the economy, which in turn increases or decreases Pareto resource misallocation in other markets.⁵²

On the grounds of complexity, then, scientific utilitarianism must be rejected as a mode of settling the question of which valuation standard should be applied in bankruptcy reorganization cases.

⁵⁰ The choice of maximand is not one that can be answered internally from ethical theory. The maximand is imposed by fiat, superstition, custom or prejudice. The difference between wealth or utility as a maximand is much less than is sometimes supposed. Wealth maximization assumes that people are entitled to the wealth their market-recognized assets can buy. Utility maximization assumes that people are equally endowed with the right to happiness. Hence, wealth maximization is nonegalitarian; utility maximization is egalitarian. Once the baseline is chosen, these maximizing systems proceed according to precisely the same methodology. See Robin Grant, Note, *Judge Richard Posner's Wealth Maximization Principle: Another Form of Utilitarianism?*, 10 CARDOZO L. REV. 815 (1989).

⁵¹ For instance, perfect markets exist in a universe without time and space. See David Gray Carlson, *On the Efficiency of Secured Lending*, 80 VA. L. REV. 2179, 2182-85 (1994). The implications of this aspect of perfect markets is disturbing, to say the least, since perfect markets organize all economic discourse. Could it be that all this discourse revolves around nothing (where "nothing" is defined as that which has no time or space)?

⁵² For a daunting vision of what would be required for economic science to meet its empirical burden, see Richard S. Markovits, *The Causes and Policy Significance of Pareto Resource Misallocation: A Checklist for Micro-Economic Policy Analysis*, 28 STAN. L. REV. 1 (1975).

Here, as elsewhere in law, wealth maximization must either remain silent in modest admission that it cannot carry its empirical burden, or it must speak fraudulently, on the basis of some ad hoc list of costs and benefits ready to hand which is dishonestly presented as a complete account of worldwide costs and benefits.

A more modest approach is a simple appeal to standards of fairness—quid pro quo or implicit exchange to compensate creditors for what they must give up when a federal bankruptcy regime is laid over their state law rights. In particular, between the time of the bankruptcy petition and confirmation, undersecured creditors surrender their right to interest compensation. Instead, during this period, debtors have the right to use collateral rent free.⁵³ This entitlement is a huge advantage for unsecured creditors, especially in chapter 11, where the proceeding may last years. To the extent the period between the petition and confirmation can be stretched out, value is transferred from the secured creditors to the unsecured creditors. Secured creditors pay a real price—loss of income—during the delay prior to confirmation.

To some courts, it has seemed fair that, if undersecured creditors are deprived of interest income during the pendency of the reorganization proceeding, they should share in the reorganization surplus. This appeal to compensatory justice appears in the very case that established the inability of undersecured creditors to collect postpetition interest—*United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd.*⁵⁴ When that case drove great Mars to faction in the Fifth Circuit, Judge Carolyn Dineen King ruled for the en banc majority that debtors did not have to pay postpetition interest for the specific reason that secured parties are entitled to going concern valuations as a quid pro quo.⁵⁵ So expressed, the mode of valuation has an ostensible ethical or political content—a compensation for a valuable right that undersecured parties had lost.

Although Judge King, in dictum, assumed that going concern valuations would be required for chapter 11, she declined in *Rash* to extend this principle to chapter 13 cases, indicating that whatever is

⁵³ Following cram down of a plan, secured creditors are entitled to receive the present value of the collateral which implies interest compensation over time. See 11 U.S.C. § 1325(a)(5) (1994).

⁵⁴ 484 U.S. 365 (1988) (Scalia, J.). On *Timbers*, see David Gray Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577 (1989).

⁵⁵ *United Savs. Ass'n v. Timbers of Inwood Forest Assocs., Ltd.* (*In re Timbers of Inwood Forest Assocs., Ltd.*), 808 F.2d 363, 373 (5th Cir. 1987) (en banc), *aff'd*, 484 U.S. 365 (1988).

true about going concern value in a chapter 11 case is not true for a wage earner plan under chapter 13.⁵⁶ Hence, for chapter 13, the first sentence of § 506(a) requires liquidation (*i.e.*, wholesale) value, but in chapter 11, that same sentence is overridden by a quid pro quo argument connected with postpetition interest. Yet undersecured creditors do not get postpetition interest in *either* chapter 11 or chapter 13. Hence, Judge King neglects to explain why the quid pro quo exchange should not override § 506(a)'s first sentence in chapter 13 cases.

Nevertheless, in *Rash*, Judge King categorically rejected her own compensation theory. She interpreted the Supreme Court's opinion in *Timbers* as holding that undersecured creditors never deserve a quid pro quo for loss of postpetition interest prior to confirmation.⁵⁷ "Consequently," she writes, "one would not expect the Court to agree that a valuation under § 506(a) for purposes of cram down should provide the creditor with additional compensation in respect of his inability to foreclose."⁵⁸ Yet Judge King herself made this argument—and in the very *Timbers* case that the Supreme Court would later affirm.

In defense of this renounced distinction, however, it may be pointed out that the secured party's loss of postpetition interest during a chapter 13 case is far less than it might be in chapter 11. Chapter 13 plans must be brought to confirmation very quickly indeed. The Federal Rules of Bankruptcy Procedure require a plan to be submitted within fifteen days of the petition.⁵⁹ A replacement value for collateral in chapter 13 might gain a secured party many thousands of dollars, where a car or truck is at stake. This share of the surplus is simply too great to cover a month or two of lost interest income.⁶⁰ In chapter 11, however, there is at least the possibility

⁵⁶ *Associates Commercial Corp. v. Rash (In re Rash)*, 90 F.3d 1036, 1053 n.23 (5th Cir. 1996) (en banc).

⁵⁷ *See id.* at 1054.

⁵⁸ *Id.*

⁵⁹ FED. R. BANKR. P. 3015(b).

⁶⁰ Judge King makes an argument that at least approaches this point. She emphasizes that secured parties do not deserve replacement value because they obtain postconfirmation cram down interest:

Any such compensation . . . would amount to a bonus to creditors. To the extent that cram down prevents the creditor from foreclosing, the creditor is already protected because it will receive payments whose present value equals the value of its security interest in the estate's interest in the property.

Rash, 90 F.3d at 1052-53 (footnote omitted). Roughly translated, this argument states that,

that the proceeding might last much longer, therefore justifying more compensation.

A less successful *quid pro quo* argument is the claim that, since reorganization plans are risky, secured creditors should have their secured claims enhanced through going concern valuations.⁶¹ Cram down already compensates these creditors, however. Cram down invokes the concept that the present value of payment over time should equal the value of the collateral.⁶² The discount rate contains a risk component already. To add more compensation by an enhancement of the secured claim would be double compensation for a single risk. For this reason, compensatory arguments cannot focus on riskiness of the plan following confirmation.

Quid pro quo is undeniably a legitimate ethical intuition.⁶³ A quite different source of legislative intuition that some have tried is causation. Thus, if it could be established that encumbered property caused the surplus—in whole or in part—then the whole or part, as the case may be, might be awarded to the secured party. This is justi-

because bankruptcy delay is very minor in chapter 13 cases, giving replacement value constitutes overcompensation for the delay.

⁶¹ See *United States v. Taffi (In re Taffi)*, 96 F.3d 1190, 1192-93 (9th Cir. 1996) (Noonan, J.); *Associates Commercial Corp. v. Rash (In re Rash)*, 31 F.3d 325, 330 (5th Cir. 1994), *modified*, 62 F.3d 685 (5th Cir. 1995), *rev'd en banc*, 90 F.3d 1036 (5th Cir. 1996). In his withdrawn opinion in *Rash*, Smith emphasized the loss of the secured party's opportunity to reinvest the principal of the loan, though his exposition is rather confusing. He cites, however, to a law review article that justifies cram down interest as compensation for this lost opportunity—not to the idea that replacement value compensates for loss of interest between the bankruptcy petition and confirmation. See *id.* at 330, citing Todd J. Zywicki, *Cramdown and the Code: Calculating Cramdown Interest Rates Under the Bankruptcy Code*, 19 T. MARSHALL L.J. 241 (1994). Thus, cram down *already* compensates for lost opportunity. A *quid pro quo* argument therefore cannot focus on postconfirmation loss of income.

Completely unsuccessful is Judge Smith's claim that, "[w]herever possible, we try to preserve the terms of the parties' original bargain so that bankruptcy is not used opportunistically to renegotiate the terms of a voluntary agreement or to generate a windfall for one party or the other." *Rash*, 31 F.3d at 330. Bankruptcy is the theater of defeated bargains. Of course, it is *precisely* the point of bankruptcy reorganization to renegotiate the terms of voluntary agreements. It is also precisely the point in chapter 13 to award a "windfall" to debtors, though the preferred metaphor is the debtor's "fresh start."

On the other side, a bad argument was presented by Judge Robert Parker, who said that wholesale value was appropriate because the secured creditor assumed the risk. See *Rash*, 62 F.3d at 688 (Parker, J., dissenting). The secured creditor assumed the risk only if the law says so. Therefore, this cannot constitute a theory of what the law should be. "She assumed the risk" can fairly be translated as "she loses, but I can't explain why."

⁶² See 11 U.S.C. §§ 1129(b)(2)(A)(i)(II), 1325(a)(5)(B)(ii) (1994).

⁶³ See JOHN RAWLS, *A THEORY OF JUSTICE* 57 (1971); Michel Rosenfeld, *Contract and Justice: The Relation Between Classical Contract Law and Social Contract Theory*, 70 IOWA L. REV. 769, 817 (1985).

fied either on fairness grounds or in order to induce future secured creditors to "cause" future surpluses or simply in the name of compensatory justice. On the other hand, if it could be established that the collateral did not cause the surplus, then courts might impose a lower liquidation value on collateral.⁶⁴ Thus, in opting for liquidation value in chapter 13 (and for going concern value in chapter 11), the *Rash* court emphasized that, in chapter 11, the "whole business" has a going concern value, which a single secured party might claim (provided the secured creditor claimed a blanket lien).⁶⁵ In chapter 13, the security interest is not in the whole of the debtor's person, but only in various items the debtor happens to own. "For example," Judge King writes, "it would be difficult to calculate the 'surplus' generated by the debtor's retention of a recliner that he sat in after returning home from an eight-hour shift at a factory."⁶⁶

⁶⁴ Two prominent commentators think that in inventory cases the collateral *causes* the surplus, and the secured creditor is entitled to a going concern valuation, provided only one secured creditor claims all the inventory. Douglas G. Baird & Thomas H. Jackson, *Bargaining After the Fall and the Contours of the Absolute Priority Rule*, 55 U. CHI. L. REV. 738, 782-87 (1988). But where the secured party claims a single item of equipment, they oppose a going concern valuation because the equipment did not *cause* the surplus. *Accord* Lincoln Nat'l Life Ins. Co. v. Craddock-Terry Shoe Corp. (*In re* Craddock-Terry Shoe Corp.), 98 B.R. 250, 254 (Bankr. W.D. Va. 1988) (Anderson, J.) (going concern value does *not* mean "value added by the collateral to a sale of the entire business"); *see also* Northeastern Copy Servs., Inc. v. Bridgeport Park Assocs. (*In re* Northeastern Copy Servs., Inc.), 175 B.R. 580 (Bankr. E.D. Pa. 1994) (Scholl, J.) (business revenues not proceeds of encumbered copy machines for purposes of § 552(b)). In the Baird-Jackson example, a piece of equipment such as a computer might be valued as if sold in the ordinary course of the secured party's or the debtor's business, but no part of the total going concern value of the firm could be allocated to the computer. Their reason: the extra value is "caused" by management and not by the equipment used by management.

This reason may suffice when management is not fungible, but it fails if management can be replaced easily. Indeed, this reason may fail *even if* management is unique. If a telephone system is repossessed from an insolvent company, going concern value may disappear faster than if the managers quit. Instead, sometimes going concern value can be attributed to the strategic position of the hard assets themselves. *See* James F. Queenan, Jr., *Standards for Valuation of Security Interests in Chapter 11*, 92 COM. L.J. 18, 57-58 (1987) (acknowledging that "in place" value is possible, though not likely). Furthermore, this assessment may suffer from the "sunk cost" fallacy: management may have been brilliant in setting up a system that works by itself, but once that brilliance is embedded in the system, a lower-level management can keep the system going. Indeed, idiot-proof systemics is itself the very hallmark of good management. If so, then management is more akin to a sunk cost or prepaid expense and so cannot be deemed necessary to *future* profits.

⁶⁵ *Associates Commercial Corp. v. Rash* (*In re* Rash), 90 F.3d 1036 (5th Cir. 1996) (King, J.) (en banc).

⁶⁶ *Id.* at 1052 n.21. Ironically, in the *Rash* case, the debtor was a truck driver and the collateral was a truck. *See Rash*, 90 F.3d at 1039. Even the weakest sense of causation should discern that the truck had some large role to play in the going concern surplus of that particular case.

Causation, however, is merely a legal presupposition disguised as an argument. Legal cause is not a natural fact. One of the lessons of the Coase theorem⁶⁷ is that, in an environment where transactions are cost-free and instantaneous, the parties will agree to create a surplus, regardless of who caused it.⁶⁸ Thus, causation is not a natural but a positive phenomenon. For this reason, any appeal to "cause" is entirely circular. We cannot know what legally causes an effect until law establishes the cause-effect relation,⁶⁹ yet the law's content is exactly what we hope causation will establish.

For instance, we could easily conclude that encumbered property does not cause a bankruptcy surplus because the automatic stay prevents the secured party from asserting any leverage. But such reasoning would certainly be unsatisfactory. The secured party's powerlessness comes only from positive law and therefore cannot ground the secured party's share of the reorganization surplus. Yet no other contrary principle of causation is better than this one, because it will equally be grounded on presupposed legal rights.

This failure of causation to solve the matter leads to another very common instinct. In order to divide the surplus, we should appeal to what would have happened if no chapter 13 plan had occurred. Thus, if "what would have happened but for bankruptcy" is a repossession and sale of collateral, then the secured party obtains all she deserves if she is given this amount as her share of the reorganization surplus. The balance of the surplus would then go to the unsecured creditors, for whose benefit the Bankruptcy Code was enacted in the first place.

This hypothetical universe in which events unfold in the absence of bankruptcy is governed by what has been called "subjunc-

⁶⁷ The Coase theorem, usually attributed to an article by Ronald Coase, holds that, in a universe without transaction costs—i.e., without time and space—proper allocations of resources (including legal entitlements) do not matter because, if the initial distribution is wrong, the parties will costlessly trade to restore the efficient allocation. Or, in a system that instantly corrects all mistakes, mistakes do not matter. See generally R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960).

⁶⁸ See generally Duncan Kennedy, *Cost-[B]enefit [A]nalysis of [E]ntitlement [P]roblems: [A] [C]ritique*, 33 STAN. L. REV. 387 (1981).

⁶⁹ Hegel was a critic of causality and found it to be nothing but presuppositional. G.W.F. HEGEL, *HEGEL'S SCIENCE OF LOGIC* 789 (A.V. Miller trans., 1969) ("But here this is no advance, since . . . cause and effect, are *relationships . . . complete in themselves* such that in them one determination is *already found* essentially linked to the other."). This is simply to say that causation is a legal idea, not a natural one.

tive information."⁷⁰ "What would have happened if . . . ?" is a question that is fundamental to human judgment and moral creativity. It is also the core of valuation theory.⁷¹ Unfortunately, historical claims in universes that never did exist are not verifiable propositions. For this reason, valuations and other subjunctive claims cannot count as objective facts, in the rigorous sense of the word. Nor can subjunctive claims disencumber themselves entirely from objective realities. Subjunctive claims are designed to have normative purchase in the ethical marketplace, which requires that they must be plausible. They have *rhetorical* force, not scientific integrity.

Consistent with the above, a court might calculate that, if there had been no bankruptcy petition, the debtor's truck would have been sold by the secured party in a commercially reasonable way in the wholesale market. This scenario is plausible, but not logically necessary. What in the nature of subjunctive reasoning prevents this alternative conclusion? "If no bankruptcy, then the debtor would have prevented foreclosure by deluging the courts with procedural objections and would have ultimately blown up the collateral with dynamite, so that the secured party's security interest has no value whatsoever."⁷² Both these histories depend upon assertions of what creative human beings "would have done," and yet human beings are capable of anything. How can we choose which one is the "true" counterfactual?

One might say, for example, that the first hypothetical history reflects ordinary events, and the second reflects extraordinary events. Between the two, pick the most "ordinary" counterfactual! Retreats to abstractions of this sort amount to the substitution of crude rules for contextual speculation.⁷³ If one must find out what would have happened to the collateral that is actually before the court (not what *generally* happens to collateral of the sort that is before the court),

⁷⁰ ROBERT NOZICK, ANARCHY, STATE, AND UTOPIA 162-63 (1974).

⁷¹ In Latin, the subjunctive mood itself is expressed by saying "worthy to"—a reference to value. Hence, the subjunctive tense of *amo* (to love) is *amanda* (worthy to be loved). In Latin, subjunctivity is *grammatically* connected to valuation of commodities.

⁷² One court held that, if a debtor would have imposed a lot of defenses as a dilatory tactic, this must be considered in valuing the collateral. See *In re Asbridge*, 66 B.R. 894, 901 (Bankr. D.N.D. 1986) (Hill, J.). Extreme litigiousness is roughly analogous to blowing up the collateral with dynamite, in many cases.

⁷³ See S. Andrew Bowman & William M. Thompson, *Secured Claims Under Section 1325(a)(5)(B): Collateral Valuation, Present Value, and Adequate Protection*, 15 IND. L. REV. 569, 572-74 (1982) (denouncing such rule-making as violating the intent of Congress).

then such abstract rules cannot be countenanced.

Alternatively, we can advertise our preferred vision of moral conduct by imagining a value based upon the secured party doing the most socially desirable thing.⁷⁴ Thus, Judge Conrad Cyr valued inventory in a famous case on the basis of the *most* commercially reasonable sale, not just on a reasonably commercial sale.⁷⁵ But in

⁷⁴ For an example of such reasoning, see J. Hobson Presley, Jr., Note, *The Cost of Realization by a Secured Creditor in Bankruptcy*, 28 VAND. L. REV. 1091, 1106 (1975). The author of this note considers a rule that limits the bankruptcy trustee to recovering from the secured party only the sales expense of collateral that the secured party would have incurred under state law. The author assumes that "what would have happened" was a peaceable surrender of the collateral. In the author's opinion, the only "rational" reason for threatening to punch a repossessing secured party in the nose is that the secured party's lien is invalid. If the security interest is valid, no breach of the peace would have occurred. Such a view substitutes the objective rules of rationality for a more contextual form of counterfactual speculation, in which parties are capable of irrational *coups de nez*.

⁷⁵ *Chemical Bank v. American Kitchen Foods, Inc. (In re American Kitchen Foods, Inc.)*, 2 Bankr. Ct. Dec. (C.R.R.) 715 (Bankr. D. Me. 1976); see also Queenan, *supra* note 63, at 23 (approving such instantiations of the good in subjunctive universes).

In *In re Waters*, 122 B.R. 298, 300-01 (Bankr. W.D. Tex. 1990), Judge Leif Clark considered the proper valuation of assets which the debtor wished to redeem as property under Bankruptcy Code § 722 for its appraised value. He rejected a liquidation valuation on policy grounds because it

calls for the creation of a "bankruptcy market" for exemption "fair market" valuations. This court sees no more reason to call such a marketplace into existence [a subjunctive note!] for redemption purposes. If anything, public policy militates against recognizing such a market, lest consumers be tempted to file chapter 7 bankruptcy solely to write down consumer debt to the detriment of the consumer credit industry. Consumer credit would either become prohibitively expensive (even more so than it is already) or dry up completely were such a "marketplace" to be opened up by the bankruptcy courts of this nation.

Waters, 122 B.R. at 301 (citations omitted). The reference to a "bankruptcy market" bears explanation. In an earlier case, a debtor claimed that the proper valuation for § 722 redemption was what a *bankruptcy trustee* could realize for the collateral. Judge Clark rejected this notion of a "bankruptcy market," *In re Mitchell*, 103 B.R. 819, 822-23 (Bankr. W.D. Tex. 1989). Indeed, such an idea also violates the subjunctive premise—what would have happened if there were *no bankruptcy*. But to call liquidation value generally the same as a "bankruptcy market" seems unwarranted as well. Liquidation might constitute a valid "no-bankruptcy" subjunctive event.

Whatever the merits of the policy invoked by Judge Clark, this substitution of a commercially reasonable valuation instead of a genuine subjunctive prediction of what would have happened if there had been no bankruptcy radically changes the nature of valuations. No longer does he consult the subjunctive universe but rather he simply legislates on the basis of some preferred moral vision.

Thus, Judge Clark rejects the secured party's claim that valuation should be based on what the secured party

itself could recover for the property if it were to repossess and resell the furniture, arguing that it is uniquely positioned to realize a high resale value because it regularly resells repossessed furniture. That approach fails to balance the debtor's interests into the overall calculation, focusing solely on maximizing [the secured party's]

pursuing such visions, it should be noted that high values based on good commercial practice in a *subjunctive* universe enriches secured creditors in our *actual* universe, even if actual creditors cannot attain to the lofty moral standards upon which such a valuation is founded.⁷⁶ If an undersecured creditor *actually* would have done a poor job in marketing collateral, then there is an argument for punishing that creditor in the subjunctive universe as well.

If abstract rules are not allowed, and if a court must *really* find out what would have happened in the absence of bankruptcy, then no *logical* reason impels one alternative history over another. Rather, choices are edited on the basis of nonlogical cultural criteria. This implies politics or aesthetics,⁷⁷ but *not* logic, not empirically verifiable claims.

B. *The Subjunctive Premises of the Debate*

Now o'er the one half-world.

Nature seems dead, and wicked dreams abuse

The curtained sleep . . . ⁷⁸

Whatever its flaws, subjunctive reasoning underlies the competing valuation exercises discussed in the important *Rash* case. The structure of this debate is to imagine that no federal bankruptcy law existed. Rather, the parties act out in a subjunctive world governed only by state law. Whatever they would have obtained in this hypothetical universe they should obtain in the bankruptcy proceeding.

The side that favors wholesale value in chapter 13 imagines that the debtor will have defaulted on a security agreement and that the secured creditor will have repossessed the collateral. The secured creditor then sells the collateral in a commercially reasonable way. When cars are at stake, it is assumed the secured creditor sells the car in the highly organized wholesale market for used cars.

The other side equally indulges in subjunctive fantasy, but its

return.

Waters, 122 B.R. at 302.

⁷⁶ This is not only true for undersecured creditors who become more fully secured as value increases, but it is also true of *oversecured* creditors, who have the right to collect postpetition interest to the extent the equity cushion increases. See 11 U.S.C. § 506(b) (1994).

⁷⁷ See Queenan, *supra* note 64, at 43 (describing valuation as an art).

⁷⁸ WILLIAM SHAKESPEARE, *MACBETH* act 2, sc. 1.

vision is different. While the liquidation analysis assumes that the secured party will go through with the foreclosure, the going concern advocates imagine that the secured party would mere *threaten* to foreclose. But the debtor has a going concern she wishes to protect, for which the collateral is useful. They imagine that, if the collateral is repossessed, the debtor will replace it.⁷⁹ Since the debtor may not have access to the wholesale market, the debtor must find a replace-

⁷⁹ See *Associates Commercial Corp. v. Rash (In re Rash)*, 90 F.3d 1036, 1051 (5th Cir. 1996) (en banc). Thus, in refusing to deduct transaction costs from the value of collateral (because transaction costs would have been incurred in a world without bankruptcy), Judge Arthur Spector wrote:

[F]oreclosure is only one way to realize the value of a lien. Other methods include allowing the debtor to discharge the lien over a period of time by making installment payments, awaiting a sale of the collateral by the debtor, or obtaining a deed in lieu of foreclosure. None of these options would require the creditor to "eat" the cost of a forced sale. Thus the deduction of hypothetical sale costs, which ironically is premised on what would happen in the "real world" [sic: should be hypothetical world that never existed], ignores the very real possibility that a foreclosure sale could prove unnecessary, and instead assumes a worst-case scenario from the creditor's perspective.

In re Jones, 152 B.R. 155, 185 (Bankr. E.D. Mich. 1993).

Dissenting in the earlier panel opinion in *Rash*, Judge Robert Parker denies the validity of the replacement value vision:

No debt can be said to be "secured" merely by the debtor's desire to retain the collateral rather than buy a replacement. Rather, a debt can be secured, within the meaning of the Bankruptcy Code, only by the value of the collateral on the creditor's repossession and sale.

Associates Commercial Corp. v. Rash (In re Rash), 62 F.3d 685, 689 (5th Cir. 1995) (Parker, J., dissenting), *rev'd en banc*, 90 F.3d 1036 (5th Cir. 1996). This remark is ineffective. The collateral is held hostage to the debtor's desire to retain it, in the vision of the replacement value. Thus, collateral is not only that which can be sold, but that which can be held for ransom. This is undeniably a feature of secured lending. Indeed, Congress enacted a liberal redemption statute in chapter 7 cases to prevent such hostage taking. See *infra* note 91.

Judge Queenan, who champions conducting valuations in a strict no-bankruptcy world, objects to a subjunctive going concern value:

Normally, outside of Chapter 11 . . . [a] mortgagor typically wishes to honor his obligation in order to avoid foreclosure, without regard to whether or not some of the mortgage debt may in fact be unsecured. But that consideration is not present in any degree here because of the Debtor's ability to obtain confirmation of a "cram down" plan proposing a payment schedule having a present value equal only to [a secured party's] "interest in the estate's interest in such property." Thus the value of the . . . mortgage can never rise above the value of its property interest aspects at the time of confirmation.

In re Robbins, 119 B.R. 1, 5 (Bankr. D. Mass. 1990) (citing 11 U.S.C. § 1229(b)(2)(A)(i)(II) (1994)). In other words, Judge Queenan dismisses the hypothetical possibility that a security interest might exceed the value of the collateral because a bankruptcy rule prevents that result. This violates the premise that we are supposed to imagine what would have happened if there were *no* bankruptcy petition.

ment in the retail market. Hence, "replacement" value becomes the gauge of "going concern" value. The possibility of replacement limits the amount of surplus the secured creditor can claim from the debtor.⁸⁰

What we have in the "replacement" vision, then, is a revision of the going concern idea. The entire going concern value of the debtor is the cash flow arising from the debtor's job. The secured creditor has the ability to withdraw the collateral unless the surplus is paid over to the creditor. But the secured creditor's access to this entire surplus is choked off by the debtor's power to abandon the collateral and use a replacement instead. Hence, as between the secured creditor and the debtor, the issue is *only* the difference between replacement value and going concern value. Given the leverage of the debtor to replace collateral, the debtor's replacement value is the most a secured creditor could hope to receive in the subjunctive half-world.

Furthermore, the going concern view assumes that the secured creditor captures *all* of this surplus and the debtor none of it. But in the subjunctive universe of no federal bankruptcy law, this does not follow. We are faced once again with a jointly owned surplus. The secured creditor can ruin the surplus by repossessing the collateral. The debtor can ruin the surplus by surrendering the same collateral. Both gain if they *compromise* and derive some sort of split of this surplus.⁸¹

⁸⁰ According to Judge Smith, dissenting in *Associates Commercial Corp. v. Rash* (*In re Rash*), 90 F.3d 1036 (5th Cir. 1996):

We need not determine the actual utility a debtor derives from collateral, however, as any particular piece of property is worth no more than its replacement cost. For example, having a truck to drive might be worth far more to an individual than it would cost him to purchase one, but any particular truck is worth no more than it would cost him to buy its equivalent. Thus, the value of retained collateral is equal to its replacement cost.

Id. at 1062 n.1 (Smith, J., dissenting).

The secured creditor in *Rash* was chastised by Judge King for taking a contradictory position that, if liquidation value was assigned to the collateral, debtors might turn around and sell the collateral for a profit. *See id.* at 1054. How could this be, if the premise is that the debtor is keeping the collateral precisely because the debtor's use is more valued than the cram down price of the collateral at wholesale value? Furthermore, as Judge King saw, this argument asserts that individual debtors can get better liquidation prices than an experienced secured creditor can—a proposition for which the secured creditor presented no evidence. *See id.*

⁸¹ A straightforward declaration that the court should split the difference between replacement and wholesale value occurs in *In re Carlan*, 157 B.R. 324, 326 (Bankr. S.D. 1993) (Schmidt, J.) ("Accordingly, this Court finds that the proper value of a vehicle in this context is somewhere between wholesale and retail, to be determined on a case-by-case basis.").

On this basis, Judge Richard Posner, in *In re Hoskins*,⁸² ruled that collateral should be valued at the *average* wholesale and replacement—a position favored by many lower courts⁸³ but by no other Court of Appeals.⁸⁴ Judge Posner's subjunctive reasoning refers not to the purchase of some other piece of property but to the outward leverage the debtor has to force the secured creditor into a compromise between liquidation value and replacement value. Hence, the scenario justifies the averaging of the two values.⁸⁵ Posner empha-

⁸² 1996 U.S. App. LEXIS 32663 (7th Cir. Dec. 12, 1996) (Posner, J.).

⁸³ *In re Mitchell*, 191 B.R. 957 (Bankr. M.D. Ga. 1995) (Laney, J.); *In re Madison*, 186 B.R. 182 (Bankr. E.D. Pa. 1995); *In re Myers*, 178 B.R. 518, 522 (Bankr. W.D. Okla. 1995) (Lindsey, J.) ("a compromise which in a vast majority of cases will provide an equitable result"); *In re Rowland*, 166 B.R. 172 (Bankr. N.D. Fla. 1994) (Killian, J.); *In re Carlan*, 157 B.R. 324, 326 (Bankr. S.D. 1993) (Schmidt, J.) ("Accordingly, this Court finds that the proper value of a vehicle in this context is somewhere between wholesale and retail, to be determined on a case-by-case basis") *In re Stauffer*, 141 B.R. 612 (Bankr. N.D. Ohio 1992) (Williams, J.); *In re Chapman*, 135 B.R. 11 (Bankr. M.D. Pa. 1990) (Woodside, J.).

In *Madison*, *supra*, Judge Stephen Raslavich chose the average value because wholesale value ignores the second sentence of § 506(a) and because it supposedly ignores the contemplation of "benefits and risks to both the creditors and the estate." 186 B.R. at 184. Retail value was rejected because it ignored the congressional desire for a case-by-case standard. *Id.* Such reasoning is not very satisfactory. Wholesale value includes risk because risk is a cost and cost is reflected in *any* mode of valuation. And Raslavich's "average" value is just as much a illicit "fixed rule" as the retail valuation he rejected. Judge Raslavich, however, did invite evidence to counteract the mere presumption of average value. *Id.*

Several districts have established average valuation of automobiles by enacting a local procedure rule. *In re Sharon*, 200 B.R. 181, 194-95 (Bankr. S.D. Ohio 1996) (Waldron, J.); *General Motors Acceptance Corp. v. Valenti*, 191 B.R. 521 (N.D.N.Y. 1995) (Cholakakis, J.).

⁸⁴ It was specifically renounced in *Associates Commercial Corp. v. Rash* (*In re Rash*), 31 F.3d 325, 331 (5th Cir. 1994) (Smith, J.), *op'n mod.*, 62 F.3d 685 (5th Cir. 1995), *rev'd*, 90 F.3d 1036 (5th Cir. 1996) (*en banc*).

At least one court has taken the line that a court must never stray from the evidence of what would have happened subjunctively. Rather, a judge should choose between the creditor's experts and debtor's experts: "[n]o court would hear two experts' evidence on DNA test results and conclude that both were half right and make a finding on that basis." *In re Byington*, 197 B.R. 130, 138 (Bankr. D. Kan. 1996) (Pearson, J.).

⁸⁵ *Id.* at 11-16. In his concurring opinion, Judge Frank Easterbrook cites *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 129-32 (1939), for the proposition that

a credible threat to litigate and other negotiating strategies do not affect the value of a debt [sic] in bankruptcy, even if as a practical matter they alter the parties' wealth outside of bankruptcy. This means that when estimating the value of a claim the judge should use an actual or hypothetical sale as the measure; the consumer surplus or going-concern value goes to the party entitled to it by contract or positive law, rather than to the party entitled to it by contract or positive law, rather than to the party with the most bargaining power.

Id. at 22-23. In *Case*, Justice William O. Douglas rejected the premise that equity owners' actu-

sized that economic theory cannot explain the process by which joint owners of a surplus would divide it.⁸⁶ Dividing the surplus in two, however, is supported by a valid subjunctive intuition with regard to going concern valuations.

In his concurring opinion,⁸⁷ Judge Frank Easterbrook challenged the subjunctive logic that led to the midpoint between wholesale and retail value. Easterbrook's own subjunctive vision is that the debtor could have let the collateral go and could have showed up at the auction, bidding an increment more than the second highest valuing user. In this vision, the debtor captured the entire joint surplus, minus the increment.⁸⁸ But this evidence is inadmissible. Under state law, in the absence of bankruptcy, the secured party could bid in its claim, driving the debtor in the auction to ever higher bids, until the debtor reached the outer limit of her use value. Hence, Judge Posner has the better of the argument. Valuation of the car is indeterminate between wholesale and retail value. A split of the joint surplus is therefore a sensible compromise.

C. *Homogeneity of Product*

Is there really an economic difference between wholesale and

al threat to litigate in bankruptcy might constitute new value justifying their participation in a reorganization plan, in spite of the absolute priority rule. The emphasis here, though, was on actuality of a holdout power in the reorganization court, not on litigiousness in the "what if" world of no bankruptcy. If litigiousness is a fact in the subjunctive half-world of the subjunctive, then how could it be excluded?

Easterbrook, who favored wholesale value, also complained that unsecured creditors are not allowed premiums for their bargaining advantages outside bankruptcy. Why then should secured parties be privileged? One answer is that the entire purpose of a federal bankruptcy proceeding is to break up the bargaining power of unsecured creditors. David Gray Carlson, *Debt Collection as Rent Seeking*, 79 MINN. L. REV. 817, 831-37 (1995). Secured creditors, however, were always exempt from bankruptcy jurisdiction, so long as the acquisition of the security interest was not preferential. Only in the Bankruptcy Code have secured creditors generally been made subject to the power of the bankruptcy trustee. Hence, as a matter of congressional intent, it is possible to see the Bankruptcy Code as hostile to the power of unsecured creditors but honoring the value of secured creditor power as the price for their participation in debtor rehabilitations.

⁸⁶ *Hoskins*, at 14-15.

⁸⁷ Judge Easterbrook concurred because the secured party had appealed from a lower court holding for the average value from wholesale and retail value. Judge Easterbrook favored wholesale value and would have so ruled if only there had been a cross appeal from the chapter 13 trustee. The debtors could not raise the possibility of wholesale value, because they had urged the average valuation in the chapter 13 level. *Id.* at 20-21.

⁸⁸ *Id.* at 30-31.

replacement (*i.e.*, retail value)? The NADA guides present two very different numbers for wholesale and retail values. Much of the judicial rhetoric on valuation standards assumes that, essentially, a positivistic legislative choice must be made between these two issues.

Yet Congress has never legislated the matter. Indeed, it openly refused to do so. Thus, we learn:

"Value" does not necessarily contemplate forced sale or liquidation value of collateral; nor does it always imply a full going concern value. Courts will have to determine value on a case by case basis, taking into account the facts of each case and the competing interests in the case.⁸⁹

Neither is it expected that the courts will construe the term value to mean, in every case, forced sale liquidation value or full going concern value. There is wide latitude between those two extremes although forced sale liquidation value will be a minimum.

In any particular case, especially a reorganization case, the determination of which entity should be entitled to the difference between the going concern value and the liquidation value must be based on equitable considerations arising from the facts of the case.⁹⁰

Such passages vexatiously refuse to indicate the rule.⁹¹

⁸⁹ H.R. REP. NO. 95-595 at 356 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6312.

⁹⁰ S. REP. NO. 95-989 at 54 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5840. This particular remark refers to § 361, but at least one court used it to justify going concern value for chapter 11 cram down. *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Savs. (In re Winthrop Old Farm Nurseries, Inc.)*, 50 F.3d 72, 74-75 (1st Cir. 1995) (Stahl, J.).

⁹¹ There is one passage, prominently cited by the majority in *Rash* in which it is said that the whole purpose of chapter 13 is to relieve debtors from having to pay replacement value, or anything in excess of the liquidation value of collateral. According to this passage:

The second important change [being recommended] is in the treatment of secured creditors. Most often in a consumer case, a secured creditor has a security interest in property that is virtually worthless to anyone but the debtor. The creditor obtains a security interest in all of the debtor's furniture, clothes, cooking utensils, and other personal effects. These items have little or no resale value. They do, however, have a high replacement cost. The mere threat of repossession operates as pressure on the debtor to pay the secured creditor more than he would receive were he actually to repossess and sell the goods. . . .

Proposed chapter 13 instead views the secured creditor debtor relationship as a financial relationship, and not one where extraneous, non-financial pressures should enter. The bill requires the court to value the secured creditor's interest. To the extent of the value of the security interest, he is treated as having a secured claim. . . .

Rash, 90 F.3d at 1056 (quoting H. REP. NO. 95-595 at 124 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6085). But this passage is from the report of the earlier National Bankrupt-

Why then must appellate courts choose at all? An alternative possibility is that the valuation standard should be left entirely to the bankruptcy court on a case-by-case basis. On this view, any reasonable choice, supported by evidence on the record, will be upheld on appeal.

No appellate court, at least, has been willing to follow this approach. Indeed, to virtually every appellate court, the valuation standard has seemed purely legislative, not adjudicative. Unless bankruptcy practice is to be lawless, there ought to be a rule, and if a rule is to be made, then appellate courts see no reason why they—not the trial court—should legislate this “question of law.”⁹²

In this respect, it may be noted that in the *Rash* case the debtor's expert inspected the truck, was in the retail business, started with a retail value, and made a 25% deduction to cover dealer profit,⁹³ “additional costs incurred by a dealer, including recondi-

cy Commission, headed up by Professor Frank Kennedy. The relation between what this commission recommended and what Congress enacted is problematic. Thus, the passage in question contradicts other passages in which valuation is said “not necessarily” to be liquidation value.

Legislative history clearly exists with regard to chapter 7 redemption, which refers to avoidance of high replacement costs. See H. REP. NO. 95-595 at 127 (1977), reprinted in 1978 U.S.C.A.N. 5787, 6088. Chapter 7 redemption usually draws liquidation value. Even here, in spite of a very specific passage from the legislative history, some courts have found for replacement value. See *McQuinn v. Dial Fin. Co.* (*In re McQuinn*), 6 B.R. 899, 900 (Bankr. D. Neb. 1980) (Crawford, J.) (though reduced by subtraction of overhead and commissions); *Catholic Credit Union v. Siegler* (*In re Siegler*), 5 B.R. 12 (Bankr. D. Minn. 1980) (Owens, J.) (setting valuation at liquidation value plus two-thirds of the difference between liquidation and retail value); see generally David Gray Carlson, *Redemption and Reinstatement in Chapter 7 Cases*, 5 AM. BANKR. INST. L. REV. (forthcoming 1996). But this cannot settle the matter for chapter 13 cases, especially where the legislative history so openly calls for a case-by-case contextual standard. Hence, the legislative history must be accounted as ambiguous. Each side in the debate can find what it wants in the legislative history.

⁹² According to Judge Richard Posner:

It is one thing . . . to say that a uniform standard of valuation must be applied case by case, since application depends on the facts and they are different from case to case. It is another thing to say that there is no standard. Although there is some support in the legislative history for such an approach, it would be peculiarly inappropriate to the valuation of Chapter 13 property. These are tiny cases. The debtor usually has few assets. To prevent the costs of bankruptcy litigation from eating up the entire debtor's estate, a simple rule of valuation is needed. Wholesale price is one simple rule; retail price another; the midpoint of the two prices is a third.

None is enacted or excluded by the statute. We must decide which is best.

In re Hoskins, 1996 U.S. App. LEXIS 32663, at 7 (7th Cir. Dec. 12, 1996) (Posner, J.) (citation omitted); see also *In re Maddox*, 200 B.R. 546, 549 (D.N.J. 1996) (Orlofsky, J.) (de novo review of bankruptcy court's interpretation of law).

⁹³ The deduction of *profit* seems dubious here. “Profit” in microeconomic terms means

tioning the truck for resale, and paying a salesperson's commission."⁹⁴ In contrast the secured creditor's expert had never seen the truck in question and was not in the retail business. Rather, he was an auctioneer. In addition, he testified that, often, the secured creditor in question bid in 92% of the retail price at a foreclosure sale.

Judge King could have held that a finder of fact was within its discretion to believe the debtor's witness. Furthermore, she could have noted that retail value *was* used, but that, after deductions for costs saved, retail and wholesale are the same value after all. In short, the openly legislative tone of both the majority and minority opinions in *Rash* could have been avoided. Valuation could have been left in the realm of fact, not of law.

Valuation theory, if properly applied by courts on a case-by-case basis, will tend to dissolve the distinction between wholesale and replacement value.⁹⁵ That the retail price is the wholesale price when dealer costs are removed is bolstered by some reflection on this question: shall the replacement be based upon the next best object in the marketplace, or shall the replacement be precisely homogeneous to what is being replaced? For example, suppose a secured party claims a car as collateral. If the new car includes a

price minus marginal cost of production. If "profit" means only what every other supplier in the market earns when selling a like commodity, "profit" is in fact the supplier's "opportunity cost," which is part of the marginal cost of production. See David Gray Carlson, *On the Margins of Microeconomics*, 14 CARDOZO L. REV. 1867, 1886-89 (1993). On the other hand, if the supplier has some market advantages based upon some inconvenience to the debtor—for example, the next car dealer is three hundred miles away, so that the debtor will pay extra to the local car dealer to save travel expense—then this "profit" stems from the nonhomogeneity of the replacing product with the replaced product, and it ought to be eliminated.

The court made a confusing remark on profit in *Associates Commercial Corp. v. Rash* (*In re Rash*), 31 F.3d 325 (5th Cir. 1994), *modified*, 62 F.3d 685 (5th Cir. 1995), *rev'd en banc*, 90 F.3d 1036 (5th Cir. 1996) where Judge Jerry Smith refused to remove "profit" from replacement value: "[w]hat is deemed 'profit,'" he wrote, "is actually the opportunity cost of keeping [the secured creditor's] money tied up in Rash's loan and the normal return on capital, without which the loan will not be made." *Id.* at 331.

It is true that a lender will not lend unless the lender obtains the "real" rate of interest—the opportunity cost of giving up principal to the debtor. This is part of the marginal cost of lending. But what does this have to do with the hypothetical replacement value of a car? Not the actual lender's profit, but the *hypothetical car dealer's* profit is what must be considered.

⁹⁴ *Associates Commercial Corp. v. Rash* (*In re Rash*), 90 F.3d 1036, 1039-40 (5th Cir. 1996) (King, J.) (en banc).

⁹⁵ See Robert M. Lawless & Stephen P. Ferris, *Economics and the Rhetoric of Valuation*, 5 J. BANKR. L. & PRACTICE 3, 11-18 (1995) (developing this theme).

warranty and an extra useful life, the value of these items should properly be deducted from the price of the car. In a similar vein, a debtor may bear expenses in order to buy the replacement. The need to incur transaction costs means that the new car is not homogeneous with the old car. True replacement value therefore might require a downward adjustment for hypothetical transaction costs.⁹⁶

It should be apparent that, before long, the replacement value precisely equals the wholesale value, once all deductions of this sort are made.⁹⁷ Thus, Judge Richard Posner, writing on the relationship between wholesale and retail prices, stated that, once the added values are subtracted from retail valuations, wholesale precisely equals retail value:

Although retail prices tend to be higher than wholesale prices, this is because it costs more to sell at retail. Not only can there be, therefore, no presumption that the net gains to the seller are different at the two levels, but economic theory implies that returns at the two levels will tend toward equality, since until they are equalized dealers will have incentives to enter at the level where the higher returns are being earned and by entering will bid those returns down.⁹⁸

Suppose, however, that none of these deductions is made. Instead, the debtor hypothetically replaces existing collateral with some nonhomogeneous product. To the extent that actual empirical conditions for replacement are considered, the secured party takes value from the unsecured creditors because of the inconvenience the debtor must undergo to secure the replacement.⁹⁹ No longer is the

⁹⁶ See *In re Rossow*, 147 B.R. 1, 2-3 (Bankr. W.D.N.Y. 1992) (Kaplan, J.); *McQuinn v. Dial Fin. Co.* (*In re McQuinn*), 6 B.R. 899, 900 (Bankr. D. Neb. 1980) (Crawford, J.) (reducing car from \$2,800 to \$1,800 because of "costs such as dealer overhead, salesman's commissions, and profit which the debtor should not be required to pay").

⁹⁷ Even the secured party in *Rash* conceded that the replacement had to be homogeneous with the replaced item—a damaging concession. See *Rash*, 90 F.3d at 1041 & n.3. In dissent, Judge Jerry Smith denied that replacement value gives secured parties any such leverage, because the replacing item must be considered homogeneous with the replaced item. *Id.* at 1070 (Smith, J., dissenting). If Judge Smith meant to condition replacement valuation upon homogeneity of the product, then replacement value equals liquidation value. Hence, reliance upon homogeneity of product is subversive to Judge Smith's position.

⁹⁸ *Contrail Leasing Partners, Ltd. v. Consolidated Airways, Inc.*, 742 F.2d 1095, 1101 (7th Cir. 1984); see also *Samson v. Alton Banking & Trust Co.* (*In re Ebbler Furniture & Appliances, Inc.*), 804 F.2d 87, 92 (7th Cir. 1986) (Easterbrook, J., dissenting) (denying the distinction between wholesale and retail value).

⁹⁹ See *Rash*, 90 F.3d at 1051.

collateral being valued. Instead the inconvenience to the debtor to acquire extra services, to obtain a longer useful life, or to undergo extra transaction costs are taken into account. Yet what is supposed to be valued is the "creditor's interest in the estate's interest in such property."¹⁰⁰ In short, replacement value, when left unadjusted for nonhomogeneous factors relating to the replaced item, does not measure the value of the collateral, but the exact situation of the debtor and her relation to things *other* than the collateral.¹⁰¹

In *Taffi v. United States (In re Taffi)*,¹⁰² Judge John T. Noonan denied replacement had any role in the valuation of a personal residence in a chapter 11 case:

The fair market value is not 'replacement value' because the [h]ouse is not being replaced. The fair market value is the price which a willing seller under no compulsion . . . to sell and a willing buyer under no compulsion . . . to buy would agree upon after the property has been exposed to the market for a reasonable time.¹⁰³

This simple formulation led Judge Noonan to order that no hypothetical transaction costs be deducted from the amount the hypothetical buyer and seller would agree upon.

What is the subjunctive vision behind this decision? Careful reflection reveals that Judge Noonan is adapting the perspective of the secured creditor¹⁰⁴ who is foreclosing on the mortgage—but with the full cooperation of the debtor. Clearly the sales price paid by the willing buyer will reflect a title that is free and clear of the secured creditor's lien. Hence, we might as well view this as a foreclosure sale.

Yet such a decision allows the secured creditors to profit from the nonhomogeneity of the house hypothetically sold and the house as it exists. Houses are typically sold with warranties of title and certificates of termite inspection. Houses heavily advertised and marketed by brokers have information values added that the existing house does not have. A house that the debtor is willing to leave after the

¹⁰⁰ 11 U.S.C. § 506(a) (1994).

¹⁰¹ See H. REP. NO. 95-595 at 124 (1977), reprinted in 1978 U.S.C.C.A.N. 5963, 6085 (secured creditors should not receive "extraneous, non-financial leverage" over debtors).

¹⁰² 96 F.3d 1192 (9th Cir. 1996) (en banc).

¹⁰³ *Id.* at 1192.

¹⁰⁴ In *Taffi*, the secured creditor was the Internal Revenue Service with a perfected tax lien on the debtor's home.

sale is more valuable than a house from which the debtor must be evicted. The fair market value summoned up by Judge Noonan ought not to include these things, because the hypothetical willing buyer is getting a better product than the house as it exists in the hands of the debtor. Hence, Judge Noonan compares the house hypothetically transformed in the subjunctive universe by these added services to the house as it actually is. "Valuation must be accomplished within the actual situation presented," Judge Noonan wrote.¹⁰⁵ But what he envisions is just as subjunctive as any other valuation exercise in which he might have engaged.

Furthermore, Judge Noonan ruled that hypothetical transaction costs must not be deducted, because the debtor intended to keep the house under the provisions of a chapter 11 plan. Yet hypothetically, Noonan refers to a sale. In order to render the hypothetically sold house homogeneous with the existing house, the value added by brokers or by title warranties should have been removed. If this had been done, the price willingly paid by the buyer would have begun to approach the lesser amount realized by a seller.

Homogeneity of product threatens to undermine the subjunctive exercise in which replacement value distinguishes itself from wholesale value. Yet if homogenization is forbidden in deference to subjunctivity, then the secured party profits from a kind of monopoly power over the debtor, who finds replacement inconvenient.

D. *Summary*

Appeals to wealth maximization, legal causation, or reciprocity cannot settle the entitlement of secured creditors to a going concern surplus in bankruptcy reorganization. Economic theory, which reduces all human values to preferences and then aggregates them quantitatively to see what legislation would make the public happier, promises to reduce an ethical dispute to an empirical question. It cannot, however, deliver the required knowledge of all costs and benefits of legislative choice. Appeals to causation, meanwhile, are circular because causation is a legislative idea and therefore cannot be used to ground legislation. Ethical theory must find some external criterion to establish law's content. Anything else constitutes a bootstrap. Finally, appeals to fairness are illuminating but controversial. Such

¹⁰⁵ *Taffi*, 96 F.3d at 1192.

arguments claim that one side deserves compensation for having lost out in some other respect. These intuitions are based on preconceived notions with which reasonable persons might disagree.

Ultimately, the question of valuation devolves to subjunctive vision. These visions have rhetorical force only and therefore cannot settle the matter for those who insist on competing subjunctive visions. Significantly, if the subjunctive premises of valuation theory are pressed, the entire distinction between replacement and wholesale valuations dissolves, so long as courts insist that the replacing item be completely homogeneous with the replaced item. Once a court insists upon homogeneity of replaced and replacing products, all the value added by the hypothetical retail seller must be subtracted out, so that the hypothetical replacement exactly matches the collateral the secured creditor hypothetically repossesses. If the distinction between wholesale and retail is thus denied, then appellate courts can follow what appears to be congressional intent—that valuation standards should be a question of fact, to be determined on the basis of evidence by the bankruptcy courts. Appellate courts should review findings of value for abuse of discretion only.

III. THE MEANING OF THE BANKRUPTCY CODE

What does the text of the Bankruptcy Code have to say on the question of wholesale versus replacement value? This issue has been the primary concern to the appellate courts who have pondered the choice between wholesale and replacement values.

Valuation matters only when a secured creditor is undersecured. If a secured claim is oversecured under any conceivable valuation rule, the entitlement of the secured creditor to the reorganization surplus is clear. The secured creditor obtains all prepetition amounts due and owing,¹⁰⁶ plus postpetition interest and attorneys' fees (when the agreement so provides).¹⁰⁷

When a claim is undersecured in light of some valuation rule, the claim must be "bifurcated" under § 506(a) of the Bankruptcy Code. According to the first sentence of § 506(a):

[1] An allowed claim of a creditor secured by a lien on property in which the estate has an interest . . . is a secured claim to the extent

¹⁰⁶ See 11 U.S.C. § 502(b) (1994).

¹⁰⁷ See 11 U.S.C. § 506(b) (1994).

of the value of such creditor's interest in the estate's interest in such property . . . and is an unsecured claim to the extent that the value of such creditor's interest . . . is less than the amount of such allowed claim.¹⁰⁸

Under this first sentence of § 506(a), an undersecured creditor becomes the owner of two quite separate claims—one perfectly secured and one perfectly unsecured. Obviously, how the collateral is valued will determine the ratio between the secured and unsecured claim.¹⁰⁹

The second sentence of § 506(a) gives advice on which method of valuation. According to the second sentence:

[2] Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.¹¹⁰

The choice between going concern value and liquidation (or replacement value and wholesale value) is often said to turn on which of § 506(a)'s two sentences predominates. Those who favor liquidation value point to the first sentence as the most important. The first sentence supposedly emphasizes that the creditor's interest must be valued, which in turn is supposed to mean that we should figure out what the creditor would have realized in a foreclosure sale conducted under the auspices of state law.¹¹¹ This is recognizable as the "what if" test of subjunctive speculation—what if there were no bankruptcy? How much would the creditor have realized in a forced sale?¹¹² Such a position favors the position of the unsecured creditors over that of the secured creditors.

¹⁰⁸ 11 U.S.C. § 506(a) (1994).

¹⁰⁹ Later, this will be called the "Scalian" ratio in honor of Justice Antonin Scalia, who in *United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988), held that this ratio must stay constant over the life of a bankruptcy proceeding. See *infra* text accompanying notes 168-70.

¹¹⁰ *Id.*

¹¹¹ See *Associates Commercial Corp. v. Rash* (*In re Rash*), 90 F.3d 1036, 1043-51 (5th Cir. 1996) (King, J.) (en banc); *In re Maddox*, 200 B.R. 546, 550-52 (D.N.J. 1996) (Orlofsky, J.); *In re 203 N. LaSalle St. Ltd.*, 190 B.R. 567, 578 (Bankr. N.D. Ill. 1995) (Wedoff, J.), *aff'd*, 195 B.R. 692 (N.D. Ill. 1996); *Overholt v. Farm Credit Servs.* (*In re Overholt*), 125 B.R. 202, 215 (Bankr. S.D. Ohio 1990).

¹¹² See *Rash*, 90 F.3d at 1067 (5th Cir. 1996) (Smith, J., dissenting). Judge Jerry Smith wittily refers to this as the "Platonic foreclosure remedy." *Id.* at 1067 (Smith, J., dissenting).

The position favoring going concern value points to the second sentence, which requires that valuation occur "in light of . . . the proposed . . . use of such property." Thus, collateral used in a reorganization implies a going concern valuation; if the property is to be liquidated in chapter 7, then liquidation values are appropriate.¹¹³ This rule therefore stresses the dubious virtue of associational logic.¹¹⁴

What follows is a closer look at the choice between the two sentences of § 506(a).

¹¹³ See, e.g., *In re Vitreous Steel Prods. Co.*, 911 F.2d 1223, 1232-33 (7th Cir. 1990) (Coffey, J.) (upholding choice of liquidation value in chapter 7 case); *In re Bergh*, 141 B.R. 409, 418-20 (Bankr. D. Minn. 1992) (Kressel, J.); *American Universal Ins. Co. v. Dunlap* (*In re Microwave Prods. of America, Inc.*), 118 B.R. 566, 574 (Bankr. W.D. Tenn. 1990) (Donald, J.) (going concern value used in reorganization case); *Downey Savs. & Loan Assn. v. Helionetics, Inc.* (*In re Helionetics, Inc.*), 70 B.R. 433, 439 (Bankr. C.D. Cal. 1987) (Ryan, J.) (going concern value must be used in chapter 11 cases, absent unusual circumstances); *Bank Hapoalim B.M. v. E.L.I. Ltd.*, 42 B.R. 376, 379 (Bankr. N.D. Ill. 1984) (Bua, J.) (liquidation value for liquidation cases, going concern value for reorganization cases); *General Elec. Credit Corp. v. Q.P.L. Components, Inc.* (*In re QPL Components, Inc.*), 20 B.R. 342, 345 (Bankr. E.D.N.Y. 1982) (Radoyevich, J.) (going concern value should be used in reorganization cases); LYNN LOPUCKI, STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS 494 (1985); Chaim Fortgang & Thomas Moers Mayer, *Valuations in Bankruptcy*, 37 UCLA L. REV. 1061, 1069-70 (1985); see also *Hearings on H.R. 31 and H.R. 32 Before the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary*, 94th Cong. 1st & 2d Sess. 495 (1975-76) (testimony of Patrick Murphy); cf. *In re Robinson Ranch, Inc.*, 75 B.R. 606, 608-09 (Bankr. D. Mont. 1987) (Peterson, J.) (chapter 12 requires use of "fair market value," not liquidation value); *In re Phoenix Steel Corp.*, 39 B.R. 218, 226-27 (Bankr. D. Del. 1984) (Schwartz, J.) (arguing liquidation and going concern value because unsure whether DIP would liquidate or remain a going concern).

¹¹⁴ As Judge William L. Norton, Jr., put it in an infamous case:

Having declared itself a fish to be reorganized, it would be inconsistent for the court now to permit the Debtor to declare itself a fowl to be liquidated for purposes of "cramming down" a lower "appraisal" value upon the secured Creditors. Therefore, a liquidation value, i.e., foreclosure value, is a procedure totally foreign to this matter and not a proper standard of valuation.

In re Pine Gate Assocs., Ltd., Bankr. Ct. Dec. (CRR) 301, 309 (Bankr. N.D. Ga. 1977) (Norton, J.). Or, for another sportsman's aphorism, "the debtor cannot eat with the hounds and run with the hares." *In re Crockett*, 3 B.R. 365, 367 (Bankr. N.D. Ill. 1980) (Eisen, J.); see also *In re Pullman Constr. Indus., Inc.*, 107 B.R. 909, 939 (Bankr. N.D. Ill. 1989) (Schmetterer, J.) ("It is grossly inequitable and unfairly discriminatory to 'cram down' forced liquidation values in a case that does not involve a Chapter 11 liquidating plan"); Isaac M. Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N. C. L. REV. 925, 939 (1980) ("It is incongruous to value a business that is being reorganized on the basis of the price its assets could fetch on a piecemeal liquidation when the entire theory of the reorganization is that the debtor is being preserved as a going concern.").

A. *The First Sentence*

The leading case to privilege the first sentence over the second on behalf of the unsecured creditors is *Associates Commercial Corp. v. Rash* (*In re Rash*),¹¹⁵ where Judge Carolyn Dineen King led a splintered Fifth Circuit in upholding the use of wholesale value for a truck in a chapter 13 case. According to Judge King:

The first sentence clearly envisions a layered analysis. The bankruptcy court must first ascertain the estate's interest in the property securing the creditor's lien. The court must then determine the creditor's interest in the estate's interest found in the first step. Finally, the court values the creditor's interest found in the second step to arrive at the amount of the creditor's allowed secured claim.¹¹⁶

From the distinction between "the estate's interest" (stage one) and "the creditor's interest" (stage two), there is supposed to emerge the insight that the estate's interest has *multiple* attributes.¹¹⁷ The "creditor's interest," however, refers only to a *single* attribute—the power to hold a foreclosure sale: "such valuation must account for the fact that the creditor's interest is in the nature of a security interest, giving the creditor the right to repossess and sell the collateral and nothing more."¹¹⁸

Thus, although Judge King elsewhere refers to the "various attributes" of the security interest,¹¹⁹ she whittles the security interest down to the monistic attribute of power to sell upon default. From the reduction of the security interest to this single attribute, there follows this conclusion: "[t]he foregoing analysis of these interests suggests a logical starting point for the valuation: what the creditor could realize if it sold the estate's interest in the property according to the security agreement."¹²⁰

¹¹⁵ 90 F.3d 1036 (5th Cir. 1996) (en banc).

¹¹⁶ *Id.* at 1043 (footnote omitted).

¹¹⁷ *See id.*

¹¹⁸ *Id.* at 1044.

¹¹⁹ *Id.* at 1043.

¹²⁰ *Id.* at 1044. In dissent, Judge Smith complains of this reduction of "creditor's interest" into one single attribute. He is able to quote a snatch from *United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd.*, 484 U.S. 365 (1988), where Justice Antonin Scalia comments on the phrase "interest in property," as that phrase is used in § 361(1)'s definition of adequate protection. *See Rash*, 90 F.3d at 1065 (Smith, J., dissenting). According to Scalia, "[t]he term 'interest in property' certainly summons up such concepts as 'fee ownership,' 'life estate,' 'co-

Later in her opinion, Judge King makes the same point in a slightly different way. Section 506(a)'s first sentence refers to "the value of such creditor's interest in the estate's interest in such property."¹²¹ Replacement value refers to *the estate's interest*, whereas the first sentence refers to the *creditor's interest*.¹²² From this it is supposed to follow that replacement value is ruled out by the first sentence.

That the phrase "the value of such creditor's interest in the estate's interest in such property" transports a court into the subjunctive world of foreclosure sales at state law by no means follows. The distinction between "creditor's interest" and "estate's interest" could reflect the fact that sometimes creditors are *oversecured*. If so, then the "creditor's interest" is not synonymous with the "estate's interest." Rather, the secured claim is limited by allowability under § 502(b), not by the value of collateral.¹²³

Even if this clause did refer to subjunctive reasoning, it also does not follow that, but for bankruptcy, what would have happened would have been a foreclosure sale. This Judge King acknowledged. Quoting legislative history that demands the choice between going concern and liquidation value be adjudicated "on equitable considerations arising from the facts of the case,"¹²⁴ Judge King viewed the foreclosure sale as merely the "starting point" from which a bankruptcy court may make "additions to or deductions" according to these "equitable considerations."¹²⁵ Nevertheless, the starting point, at least, is associated by Judge King with the result demanded by state law. Based on what has been said about subjunctive reasoning, however, the association of a hypothetical foreclosure sale with the state law result is not required. In the end, Judge King has identified a *possible* reading of the first sentence—not a required reading.¹²⁶

ownership,' and 'security interest' more readily than it does the notion of 'right to immediate foreclosure.'" *Timbers*, 484 U.S. at 371. Nevertheless, Scalia goes on to say that the phrase *might* refer to the right of immediate foreclosure after all, and so he embarks upon a "holistic" reading of the Bankruptcy Code to see if present value of the secured claim has to be protected with interest compensation. *See generally id.*

¹²¹ 11 U.S.C. § 506(a) (1994).

¹²² *See Rash*, 90 F.3d at 1048. The dissent has no good refutation of this reading except to say that Judge King took "creditor's interest" "out of context." *Id.* at 1067 (Smith, J., dissenting).

¹²³ *In re Hoskins*, 1996 U.S. App. LEXIS 32663, at 8 (7th Cir. Dec. 12, 1996) (Posner, J.).

¹²⁴ S. REP. NO. 95-989 at 54 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5840.

¹²⁵ *Rash*, 90 F.3d at 1048.

¹²⁶ In dissent, Judge Jerry Smith complains that the perpetuation of state law requires that

Incidentally, if wholesale value is just a "starting point," from which judges may depart on the basis of the evidence presented, why was it necessary to make a semi-legislative choice of wholesale over replacement value? Either starting point should be equally good from which to launch the subjunctive investigation. Earlier it was suggested that valuation should be viewed as a finding of fact, to be worked out on a case-by-case basis.¹²⁷ This is what the legislative history of the Bankruptcy Code demands. If Judge King means to invite subjunctive speculation, what need we any starting point at all?

Those who read the first sentence of § 506(a) as referring to a hypothetical foreclosure sale on a "what if no bankruptcy" basis must still account for the second sentence's admonition that valuation occur in light of the debtor's actual use. To press the second sentence into the servitude of the first, Judge King, in *Rash*, divides the sentence into two sub-requirements. First, valuation must occur "in light" of the *purpose* of the valuation, and also the valuation must occur "in light" of "the proposed disposition or use of such property."¹²⁸ As to "purpose," Judge King thought the second sentence only meant that valuations have no *res judicata* effect. A value found for one purpose would therefore not be binding with regard to a hearing for another purpose.¹²⁹ As to "use," King writes that "[t]he phrase 'in light of' . . . suggests that the court need only *consider* the proposed disposition . . . [w]e would expect Congress to use more forceful language if the proposed disposition or use of the collateral were to have a positive or negative effect on value in every case."¹³⁰ Thus, if the collateral were to be used more intensively than such collateral is typically used, a court might degrade the collateral's value "in light of" such use.¹³¹ This position is borrowed from an

state law have a valuation practice in a reorganization context. Yet no such state law exists. See *id.* at 1068-69 (Smith, J. dissenting). This point has some merit, although state law has receiverships, which might be viewed as a kind of reorganization procedure. Nevertheless, receivership law has never extended jurisdiction so radically over secured creditors as the Bankruptcy Code currently does. Even federal jurisdiction over undersecured creditors did not precede the Bankruptcy Code. See Carlson, *supra* note 53, at 581-84. Hence, valuation of undersecured claims is quite *sui generis*, as Judge Smith indicates. See *Rash*, 90 F.3d at 1074 (Smith, J., dissenting).

¹²⁷ See *supra* notes 88-96 and accompanying text.

¹²⁸ *Rash*, 90 F.3d at 1045.

¹²⁹ See *id.* at 1045-46.

¹³⁰ *Id.* at 1049.

¹³¹ See *id.*, (quoting Queenan, *supra* note 63, at 37); *In re Claeys*, 81 B.R. 985, 992 (Bankr. D.N.D. 1987) The dissent, in turn, complains that Judge King's reading of the second sentence

important essay on bankruptcy valuation by Judge James Queenan, on which Judge King substantially relies. Queenan's position is simply that judges should always imagine a sale by a secured party, and therefore nothing about the fact of a going concern should *determine* a valuation standard (although it may have some impact on how the subjunctive speculation should proceed).¹³² In his essay, Judge Queenan writes that "[t]he debtor's use of the collateral is relevant to valuation if the nature of that use physically affects the value of the collateral, either for good or bad."¹³³ Hence, he can account for the second sentence of § 506(a) in his theory of liquidation value.

But "what if" speculation cannot so easily be infected by actual historical events in the bankruptcy proceeding. The "what if" game asks what would have happened had the bankruptcy *never* occurred. Any consideration of postbankruptcy use therefore violates the rules of this particular game.

For example, suppose a debtor wishes to drive a car two hundred miles a day over poor roads—far more than the average commute. Would this affect the present value of the car, before the commute actually begins? The answer has to be no, because, by definition, the car is hypothetically taken from the debtor and put into the hands of a buyer, who will not be making the same commute, but some other, different commute.¹³⁴ Therefore, if a hypothetical sale must be imagined, then the debtor's idiosyncratic use is necessarily erased in favor of a hypothetical buyer's use.¹³⁵

means that the second sentence will hardly ever be used. Instead, the first sentence's alleged meaning (hypothetical foreclosure sales) will dominate. *See id.* at 1067 (Smith, J., dissenting); *cf. In re Robbins*, 119 B.R. 1, 4-5 (Bankr. D. Mass. 1990) (Queenan, J.) (conceding that consideration of debtor disposition or use is worthless, where liquidation value is assumed to be the standard).

¹³² *See Robbins*, 119 B.R. at 4 (Queenan, J.) ("Use of collateral by a debtor, even by one who has placed his financial house in order, is a neutral factor in establishing a standard of valuation"); *In re T.H.B. Corp.*, 85 B.R. 192, 196 (Bankr. D. Mass. 1988) (Queenan, J.) ("The fact that the debtor is a going concern is no reason to value the collateral under the going concern standard unless it appears likely that the secured party will actually receive that value from its collateral through a pending sale."). *But see In re Tenney Village Co.*, 104 B.R. 562, 567 (Bankr. D.N.H. 1989) (Queenan, J.) (using liquidation value but inexplicably including the value added to nearby property by the presence of a going concern).

¹³³ Queenan, *supra* note 64, at 33.

¹³⁴ A similar point is relevant when debtors argue for a going concern value is *lower* than liquidation value. *See supra* note 9.

¹³⁵ Dissenting in an earlier, to-be-overruled panel opinion in *Rash*, Judge Robert M. Parker, who favored wholesale value, also suggested that the fact that the collateral would be used

This point was later conceded by Judge Queenan in *In re Robbins*.¹³⁶ There, Queenan points out that whereas § 506(a) bids us to consider how the property is to be used (in a nonhypothetical universe), it also specifies that the thing to be valued is not *the* collateral but the creditor's *lien* on the collateral.¹³⁷ According to Judge Queenan: "[t]his wording is crucial . . . [t]he phrase 'the value of such creditor's interest' is not equivalent to the value of the collateral."¹³⁸ This need to value the *lien* (not the collateral) negated the requirement that actual intended use of the collateral affect valuation:

It makes no sense to attach independent significance to the Debtor's use of the property. Use of collateral by a debtor, even one who has placed his financial house in order, is a neutral factor in establishing a standard of valuation. We are dealing here with valuation of a mortgage interest and not the property itself. Except to the extent that a sale at fair market value is a substantial possibility, a security interest is worth what it will bring at a commercially reasonable foreclosure.¹³⁹

by the debtor would impact upon the wholesale worth of the car. See *Associates Commercial Corp. v. Rash* (*In re Rash*), 62 F.3d 685, 688-89 (5th Cir. 1995) (Parker, J., dissenting), *rev'd en banc*, 90 F.3d 1036 (5th Cir. 1996). Thus, the second sentence, demanding that debtor use be considered, is fully honored in wholesale valuations. This must be challenged, however. A valuation as of confirmation invokes what a buyer would pay for the car on that day. A debtor's intent to use the car in the future would be irrelevant, because the hypothetical sale would divest the debtor of all title. Only the hypothetical *buyer's* use would be relevant to what the buyer would pay for the car.

In a somewhat different vein, Parker also thought that a wholesale valuation honored the second sentence, because "[t]he purpose of determining the present value of the collateral [in a confirmation hearing] is to see to it that the creditor will receive as much money under the plan, per § 1325(a)(5)(B), as the creditor would receive were it permitted to sell the collateral in a commercially reasonable manner." *Id.* at 688 (Parker, J., dissenting). Thus, *assuming* that wholesale value is correct, the second sentence is honored because the court will be considering "the purpose of the valuation and the proposed disposition or use" when it finds the wholesale value. Of course, this reconciliation of the second sentence presupposes the correctness of wholesale valuations, which is the very issue the court had to decide. In short, Judge Parker's reasoning is circular.

¹³⁶ 119 B.R. 1 (Bankr. D. Mass. 1990).

¹³⁷ See *id.* at 3; see also 11 U.S.C. § 506(a) (1994) ("An allowed claim . . . is a secured claim to the extent of the value of *such* creditor's interest in the estate's interest in such property.") (emphasis added).

¹³⁸ *Robbins*, 119 B.R. at 3 (quoting § 506(a)).

¹³⁹ *Id.* at 4. The assumption that, but for a bankruptcy, a foreclosure sale would be *commercially reasonable*—a disputable proposition (as are all propositions about valuation)—is discussed *supra* in the text accompanying notes 70-73.

Thus, because we must value the lien (not the collateral) we are thrown entirely into the subjunctive universe of untrammelled speculation with no need to consider how the property is being used in the actual postpetition universe. Liens, Queenan implies, have meaning only in a foreclosure, and so we must ignore the debtor's intent to retain the collateral and attend only to the imagined foreclosure.

If Judge Queenan is right, then the beginning of § 506(a) requires us to imagine value in a no-bankruptcy world. This logically precludes any consideration of what is to become of the collateral in the real world. The last part of § 506(a) must therefore be ignored, because the collateral actually used has nothing to do with the lien being subjunctively valued. Subjunctive reasoning and history don't mix.¹⁴⁰

Yet, inconsistently, Queenan also indicates that he would have used the *actual* sales price in a case where the trustee sold the collateral.¹⁴¹ Thus, Queenan is not quite willing to commit totally to subjunctive reasoning. If he had been, an actual sale would have been irrelevant. Instead, a potentially lower value could be assigned the collateral, and the trustee could keep a profit from selling the collateral for a higher price in the real world.¹⁴² Apparently, this arbi-

¹⁴⁰ Judge Jerry Smith, in his dissenting opinion in *Rash* complains that, according to the majority, "courts need only consider [disposition and use] and may then set it aside when actually determining value." *Associates Commercial Corp. v. Rash* (In re *Rash*), 90 F.3d 1036, 1067 (5th Cir. 1996) (en banc) (Smith, J., dissenting).

¹⁴¹ See *Robbins*, 119 B.R. at 3-4; see also *In re Ledgemere Land Corp.*, 125 B.R. 58, 62 (Bankr. D. Mass. 1991) (Queenan, J.); *In re Tenney Village Co.*, 104 B.R. 562, 566 (Bankr. D.N.H. 1989) (Queenan, J.). In *In re Plunkett*, 191 B.R. 768 (Bankr. E.D. Wis. 1995), *aff'd*, 82 F.3d 738 (7th Cir. 1996), a valuation occurred in which a secured creditor seemed to have an equity cushion. Later, the collateral was abandoned and sold for an amount below the prepetition secured amount. The secured creditor claimed that postpetition interest had accrued and was therefore part of the allowable secured claim. See *id.* at 778. Judge C.N. Clevert disagreed, insinuating that the early valuation was purely a mistake; the subsequent sale price was the true value of the collateral, and it was apparent that the secured party was never secured. See *id.* at 779.

¹⁴² On this arbitrage possibility, see David Gray Carlson, *Undersecured Claims under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral*, 6 BANKR. DEV. J. 253 (1989); Tracey Springer, Note, *Selling Out Undersecured Creditors: "Value" Under § 363(f) of the Bankruptcy Code*, 8 CARDOZO L. REV. 1251, 1254 (1987). One case in which the actual sale was ignored was *In re Costello*, 184 B.R. 166 (Bankr. M.D. Fla. 1995), where a secured creditor bid in a very high amount at a foreclosure sale, allegedly because two "shills" allied with the debtor had bid the price up. Later, the secured creditor resold at a much lower price. The second price was used to establish the value of the collateral, which allowed the secured creditor to assert a larger unsecured deficit claim in the bankruptcy. See *id.* at 171. In so deciding,

trage between real and subjunctive markets was more than even a dedicated subjunctivist could bear.¹⁴³

Judge King, in *Rash*, makes a different argument which adequately justifies ignoring the debtor's actual use in arriving at a hypothetical liquidation value. She points out that § 506(a)'s second sentence covers a large number of procedures.¹⁴⁴ One of them is the motion to lift the automatic stay for failure to provide adequate protection.¹⁴⁵ Here, debtor use helps to reveal to what extent the collateral is depreciating in value. This in turn reveals whether the secured party should have an adequate protection remedy under § 361.¹⁴⁶ Thus, if we outright ignore debtor use in a cram down valuation, we do not render the second sentence of § 506(a) utterly superfluous. That sentence still has utility, because cram down is not the only procedural context for valuation.¹⁴⁷

To summarize, those who favor liquidation value on the privilege of § 506(a)'s first sentence also rely on the controversial premise that, but for the bankruptcy, the secured party would have sold the property in a foreclosure sale (at wholesale value). Yet this position cannot adequately account for the debtor's actual use, because actual use is precluded by the rules of subjunctive speculation.

B. *The Second Sentence*

Those who favor going concern value in reorganization cases claim that the second sentence of § 506(a) compels it by referring to the debtor's disposition or use. Dissenting in *Rash*, Judge Jerry Smith reads the first sentence of § 506(a) to mean only that "the amount of a secured claim is the value of the collateral; it does not tell us how to determine that value."¹⁴⁸ It is the *second* sentence that gives

Judge Alexander Paskay clearly intimated that the bid-in sale was not "real." But why shouldn't the foolish bid of an actual buyer—even in the bid-in situation—establish value? Value is based on the esteem of actual buyers—not rational buyers—in the market place. Rationality of buyers is merely an economic theoretic construct.

¹⁴³ See *Associates Commercial Corp. v. Rash* (*In re Rash*), 31 F.3d 325 (5th Cir. 1994) (Smith, J.) (choosing retail over wholesale value of collateral in order to reduce the chance that the debtor might resell the collateral at a profit after a chapter 13 plan was confirmed), *modified*, 62 F.3d 685 (5th Cir. 1995), *rev'd en banc*, 90 F.3d 1036 (5th Cir. 1996).

¹⁴⁴ See *Rash*, 90 F.3d at 1045.

¹⁴⁵ See 11 U.S.C. § 362(d)(1) (1994).

¹⁴⁶ 11 U.S.C. § 361 (1994).

¹⁴⁷ See *Rash*, 90 F.3d at 1049-51.

¹⁴⁸ *Id.* at 1061 (Smith, J., dissenting).

instruction on how to value property, according to Judge Smith.¹⁴⁹

The second sentence requires valuation to be determined in light of the "the proposed disposition or use" of the collateral. In the view of many courts, this admonition to consider "use" translates directly into the replacement valuation standard. But why? According to Judge Smith, dissenting in *Rash*:

Section 506(a) is not difficult to interpret. Read as a whole, it plainly means that when a reorganizing debtor retains and uses collateral, we must value the property according to its worth to the debtor (the actual user), not to the creditor (a purely hypothetical seller).¹⁵⁰

Does it follow that, because we contemplate the debtor's use of the collateral, we must now value the collateral from the perspective of the debtor? In *Rash*, Judge Carolyn Dineen King for the majority

¹⁴⁹ *Accord* Metrobank v. Trimble (*In re Trimble*), 50 F.3d 530, 532 (8th Cir. 1995) (Ross, J.). In *In re Green*, 151 B.R. 501, 503 (Bankr. D. Minn. 1993), Judge Nancy Dreher noted that the first sentence of § 506(a) points to wholesale (liquidation) value, but the second points to retail (going concern) value. The issue in this case was to decide which sentence of § 506(a) trumped the other. In particular, Judge Dreher worried that assigning a wholesale value would read the second sentence of § 506(a) out of the Bankruptcy Code.

If the plain meaning of the first sentence is interpreted as liquidation value, and the second is interpreted as going concern value, Dreher rejected the argument that by choosing the second sentence she was depriving the first sentence of its efficacy. She stated:

It must be remembered that a lien is fundamentally a security interest which secures payment of an obligation. To value such an interest in property based solely on the amount that could be realized upon sale of the collateral ignores the value associated with the right to receive the stream of payments that the lien secures. . . . Thus, where the debtor proposes to retain the collateral and pay the creditor in satisfaction of its lien, valuing the lien based on the stream of payments the creditor should receive, rather than the amount the lienholder would receive upon disposition of the collateral, does not ignore the fact that it is the lien interest that is being valued.

Id. at 505. In other words, if the debtor is to retain collateral, the collateral should be valued based on the present value of the amounts due on the secured obligation. *Accord Trimble*, 50 F.3d at 531; *Associates Commercial Corp. v. Rash* (*In re Rash*), 31 F.3d 325 (5th Cir. 1994) (Smith, J.), *modified*, 62 F.3d 685 (5th Cir. 1995) (Smith, J.), *rev'd en banc*, 90 F.3d 1036 (5th Cir. 1996).

This makes no sense at all. If a secured party lends the debtor a million dollars at the market rate of interest and takes back a security interest on a car, this does not make the car worth a million dollars. Furthermore, since Judge Dreher attempted to show the continued efficacy of the first sentence of §506(a), it is hard to see how the above remark does the trick. In short, it is an error to mix up the secured party's *ex ante* expectation of recovering debt service and the secured party's entitlements once bankruptcy has ensued. The secured party's *ex post* rights must not be confused with the secured party's *ex ante* (and now defeated) expectations.

¹⁵⁰ *Rash*, 90 F.3d at 1061 (Smith, J., dissenting).

denied the connection between debtor use and valuation from the perspective of the debtor.¹⁵¹

A defense of Judge Smith's conclusion—consideration of debtor use leads to valuation from the perspective of the user—must connect the collateral to the surplus created by the debtor's use. But how may this be done?

One answer offered by Smith is the assertion that the collateral *causes* the surplus.¹⁵² Hence, if a reorganization proceeding produces a surplus over a hypothetical liquidation for the benefit of the unsecured creditors, and if the collateral *caused* the surplus, then the debtor's use of the collateral requires an award of at least some of the surplus to the secured party whose property enabled the surplus to exist.

As we have seen, arguments based on causation assume their premises.¹⁵³ Causation is a legal result, not a legal argument. For example, causation presupposes a secured creditor could veto the surplus by withdrawing the collateral—an entitlement that only pre-existing law could provide. Since "cause" comes from positive law, causation cannot prove what the content of positive law ought to be. On the other hand, suppose we are to take state law as determinative of what the federal law of bankruptcy valuation ought to be. In this case, causation is nothing but subjunctive "what if" speculation. Causation thus devolves into the subjunctive vision of what would have happened if the bankruptcy proceeding did not exist.

Judge Smith's dissenting view therefore is every bit as subjunctive as that of Judge King's majority view.¹⁵⁴ But his vision is differ-

¹⁵¹ See *id.* at 1047-48 ("logic corrupted by an obvious non sequitur"). Furthermore, Judge King suggests that valuing the collateral from the perspective of the debtor means that "the estate's interest" in the collateral is being valued, whereas the first sentence of § 506(a) demands that "the creditor's interest" in the estate's interest be valued. *Id.* at 1048. That is, emphasis on the second sentence contradicts the command of the first sentence, which King took to be the superior of the two sentences.

King's point, however, is troubled by the fact that, in chapter 13, the debtor is not the trustee. See 11 U.S.C. §§ 1302-03 (1994). Hence, valuing collateral from the debtor's perspective is not valuing "the estate's interest" but rather valuing the debtor's interest in anticipation of a confirmed plan. Because of this complexity, Judge King's point is much blunted.

¹⁵² See *Rash*, 90 F.3d at 1066 (Smith, J., dissenting) ("It makes perfect sense to award much of the surplus to secured creditors, as it exists only because of their collateral."); see *id.* at 1072 (Smith, J., dissenting). ("The surplus exists only because of their collateral, and even if the replacement approach caused them to receive the entire surplus, unsecured creditors would be no worse off than if they had foreclosed immediately.")

¹⁵³ See *supra* notes 64-69 and accompanying text.

¹⁵⁴ Judge King was quick to point out that the entire claim valuation process was purely

ent. In Smith's subjunctive universe, a rational debtor will not permit the foreclosure but will attempt to reach a work-out arrangement with the secured party. Hence, Judge Smith is correct in criticizing the majority in *Rash* for assuming that "what would have happened" is a foreclosure sale. Yet he is to be faulted for claiming too ambitiously that the complete capture of replacement value by the secured creditor is the necessary result of the subjunctive exercise. A reference to the dynamics of replacement does nothing more than produce another, different sort of jointly owned surplus—the difference between replacement cost and wholesale price—which the secured creditor and the debtor must divide. Once again, economic theory provides no method by which such a jointly owned surplus can be divided.¹⁵⁵

In defending replacement value, Judge Smith claimed that replacement value is *actual*, but liquidation value is *hypothetical*, when the reorganization proceeding contemplates no liquidation. He admitted that replacement value requires a hypothetical exercise in imagining the acquisition of the replacement, but this is merely *evidence* of the underlying substance.¹⁵⁶ This Spinozan remark, however, must be rejected. When it comes to value, there is no *there* there. There can be no measure of an *actual* value. Value *is* measure and has no existence outside of that, as Judge King emphasized for the majority.¹⁵⁷ There is no more actuality in replacement value than in liquidation value. Both are subjunctive visions of a no-bankruptcy

hypothetical. See *Rash*, 90 F.3d at 1048.

¹⁵⁵ See text accompanying *supra* note 86.

¹⁵⁶ According to Judge Smith:

[T]he majority confuses evidence with substance. As an evidentiary matter, any valuation method must postulate the price at which retained property would be bought or sold. In terms of substance, however, the replacement approach considers the *actual* value of the property to the person who *actually* possesses it; replacement cost is simply a measurement of that value. On the other hand, the foreclosure approach uses a hypothetical transaction to define value, not to measure it.

Rash, 90 F.3d at 1068 (Smith, J., dissenting). Later in his opinion, Judge Smith mysteriously wrote that "[t]he replacement approach looks to a debtor's replacement cost not as a reflection of value inherent in the property, but as a measurement of the value of the collateral to him." *Id.* at 1073 (Smith, J., dissenting). Here he seemed to say that value is not *actually* in collateral, but is rather nothing but pure measurement.

¹⁵⁷ But see *id.* at 1071 (Smith, J., dissenting) ("[W]e could adopt either approach as a starting point and then permit *ad hoc* departures."). Judge Smith, however, went too far in claiming that, quantitatively, his favored valuation standard is "the most case-by-case approach." *Id.* (Smith, J., dissenting). Instead, it would seem that each approach is equally subjunctive and subject to imaginative reconstruction.

world, concocted to legislate property entitlements in the actual world of bankruptcy.

In truth, the admonition of the second sentence of § 506(a) to consider the debtor's use simply becomes, at most, an admonition to change the vision of the subjunctive universe wherein the valuation of the secured party's rights is tested. Yet, as we have seen, the vision of a secured creditor hold-up does not prove that the secured party should receive replacement value. Instead, it only establishes that the secured party and the debtor jointly own a surplus comprised of the difference between liquidation value and the cost of replacement. Just because the debtor has a net use value in collateral does not prove that this value belongs to the secured creditor. Rather, it proves that valuation has an upper limit (replacement value) and a lower limit (foreclosure or wholesale value). Nothing more than this can be drawn from § 506(a)'s second sentence.¹⁵⁸

C. *Timbers of Inwood Forest*

We have seen that going concern valuations have been justified as a quid pro quo for the denial of interest compensation to undersecured creditors—a distributive point drawn from the landmark case of *United Savings Association v. Timbers of Inwood Forest Associates, Ltd.*¹⁵⁹ Different arguments have also been ventured based upon other aspects of Justice Antonin Scalia's opinion in that case.

In *Timbers*, Justice Scalia attempted to find the meaning of § 361,¹⁶⁰ which helps to define how a bankruptcy trustee might provide adequate protection to a secured creditor. In § 361, the phrase used is "value of such entity's interest."¹⁶¹ Scalia decided that § 506(a)'s phrase "value of such creditor's interest" was identical in meaning. In so concluding, he remarked "[t]he phrase 'value of such creditor's interest' in § 506(a) means '*the value of the collateral.*' We think the phrase 'value of such entity's interest' in § 361(1) and (2), when applied to secured creditors, means the same."¹⁶² Seizing upon this translation by Justice Scalia of "value of such creditor's interest" into "the value of the collateral," Judge Smith, in *Rash*,

¹⁵⁸ See *supra* text accompanying notes 75-88.

¹⁵⁹ 484 U.S. 365 (1988).

¹⁶⁰ 11 U.S.C. § 361 (1994).

¹⁶¹ *Id.*

¹⁶² *Timbers*, 484 U.S. at 372 (emphasis added) (citations omitted) (quoting 11 U.S.C. §§ 506(a), 362(1)-(2) (1994)).

thought that, according to Justice Scalia, the first sentence of § 506(a) provides no guidance to valuation standards.¹⁶³ That advice, he reasoned, was supplied solely by the second sentence.

For the *Rash* majority, Judge King declined to accept this "invitation to give uncritical treatment to the words 'the value of such creditor's interest in the estate's interest in such property' simply because they have been judicially distilled to the phrase 'the value of the collateral.'" ¹⁶⁴ In short, the Supreme Court was guilty of "uncritical treatment" of § 506(a) and its analysis could therefore be ignored. On this view, *Timbers* has nothing to say about the valuation standards in reorganization cases.

Other courts have found Justice Scalia's opinion pregnant with meaning. In *In re Green*,¹⁶⁵ Judge Nancy Dreher suggested that *Timbers* demands the choice of retail value over wholesale value in chapter 13 cases:

In *Timbers*, the Supreme Court . . . observed that the interest being protected under § 362(d)(1), like the interest being valued under § 506(a), is merely a security interest, which is a right to have the collateral applied in satisfaction of a debt, not a right to immediate possession of the collateral. Where the value of the collateral is less than the amount owed to the secured creditor, the Court stated that "[t]he phrase 'value of such creditor's interest' in § 506(a) means 'the value of the collateral.'" It would run contrary to *Timbers* to hold that the value of an undersecured creditor's lien interest is some amount less than the full value of the collateral.¹⁶⁶

Thus, a liquidation valuation would violate Scalia's remark that secured creditors should get the "value" of the collateral. Liquidation value is allegedly not *full* value. This remark is most unconvincing. Even if *Timbers* requires the secured party to obtain the *full* value of the collateral, this could easily be achieved if full value means full *liquidation* value. "Full value" points inexorably neither to liquidation value nor to going concern value.

In now-overruled *General Motors Acceptance Corp. v. Mitchell* (*In re Mitchell*),¹⁶⁷ Judge Mary Schroeder read *Timbers* to the opposite ef-

¹⁶³ See *Rash*, 90 F.3d at 1064 (Smith, J., dissenting).

¹⁶⁴ *Id.* at 1043 (quoting 11 U.S.C. § 506(a); *Timbers*, 484 U.S. at 372).

¹⁶⁵ 151 B.R. 501 (Bankr. D. Minn. 1993).

¹⁶⁶ *Id.* at 505-06 (citations omitted).

¹⁶⁷ 954 F.2d 557, 560 (9th Cir.) (1992). This opinion was declared overruled in *Taffi v.*

fect—that it requires *wholesale* value, because the *Timbers* court emphasized the need to value the *creditor's* interest. Wholesale, she reasoned, is what the creditor would get, and so *Timbers* implies wholesale.

Meanwhile, Judge Judith Wizmur, in *In re Maddox*,¹⁶⁸ thought that *Timbers* points to liquidation (*i.e.*, wholesale) value for a different reason. Wizmur cited the “Scalian ratio,” wherein Justice Scalia insisted that the ratio of secured to unsecured claim should be stable over time. Accrual of postpetition interest violated the ratio by increasing the secured claim over time, while the unsecured claim remained stable. According to Judge Wizmur, this ratio meant that *Timbers* “appears to reject the concept that a debtor’s use of collateral from the date of the filing of a bankruptcy petition should cause the value of a creditor’s interest to increase.”¹⁶⁹ In other words, embedded in the Scalian ratio is the notion that the collateral must be valued as if sold immediately, which implied a liquidation, not a going concern, value.

The Scalian ratio is indeed a very static idea, suggesting that *some* value should be set at the beginning of the bankruptcy proceeding. But why should this value be a subjunctive liquidation value? All the ratio requires is stasis, not some particular subjunctive theory. Hence, the Scalian ratio is an indeterminate source of wisdom. It is also, on its own terms, a poor description of the Bankruptcy Code, which seems to bless improvements of position by undersecured creditors after bankruptcy.¹⁷⁰ Therefore, the ratio should be rejected for all purposes as a lodestar. Rather, it should be viewed as an interesting but unsuccessful rhetorical flight of fancy, worthy to be banished with honor to the twilight world of “mere dictum.”

D. *Perpetuating State Law and Pre-Code Practice*

A further argument for liquidation over going concern value harnesses itself to the aphorism that says, where the Bankruptcy Code is ambiguous, courts should presume that state law or pre-Code law should continue.¹⁷¹ In *Rash*, Judge King suggested that

United States (In re Taffi), 96 F.3d 1190 (9th Cir. 1996) (Noonan, J.) (en banc).

¹⁶⁸ 194 B.R. 762 (Bankr. D.N.J.), *aff'd*, 200 B.R. 546 (D.N.J. 1996) (Orlovsky, J.).

¹⁶⁹ *Id.* at 769.

¹⁷⁰ See, e.g., 11 U.S.C. § 552(b) (1994).

¹⁷¹ See, e.g., *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994) (Scalia, J.); *Midlantic Nat'l Bank v. New Jersey Dep't of Envtl. Protection*, 474 U.S. 494, 501 (1986) (Powell, J.); *Butner v.*

both state law and pre-Code law point to liquidation value in lieu of going concern value.¹⁷²

As to state law, Judge King claimed that a secured party has the right to foreclose upon default.¹⁷³ This is true enough, but it does not follow from this that state law dictates a secured party must get only liquidation value from collateral. A foreclosure sale might produce a going concern price, as has been emphasized.¹⁷⁴ Or it might result in the debtor redeeming the collateral by paying the entire claim.¹⁷⁵ Or it might result in a workout agreement with the secured party, in which the two sides split the difference between them.¹⁷⁶ Thus, it does not follow that the continuation of state law requires liquidation value.

In dissent, Judge Smith points out that there is no state law of reorganization dictating a specific standard of valuation and hence no grounds from which to perpetuate state law.¹⁷⁷ In this he is probably correct. Bankruptcy law probably innovates when it displaces the secured party's unilateral right to foreclose in favor of a forced compromise of the secured claim. In any case, the willingness of state courts to stay foreclosure so that junior creditors can maximize debtor equity would have to be demonstrated through painstaking historical research.¹⁷⁸ The matter is difficult because the very success of the federal bankruptcy law has stultified the development of the state law of receiverships and assignments for the benefit of creditors.¹⁷⁹

United States, 440 U.S. 48, 55 (1979) (Stewart, J.).

¹⁷² See *Associates Commercial Corp. v Rash* (*In re Rash*), 90 F.3d 1036, 1045-47 (5th Cir. 1996) (en banc).

¹⁷³ See *id.* at 1042.

¹⁷⁴ See *supra* text accompanying notes 71-73.

¹⁷⁵ U.C.C. § 9-503 (1996).

¹⁷⁶ See *supra* text accompanying notes 80-88.

¹⁷⁷ See *Rash*, 90 F.3d at 1069 ("Replacement valuation would not 'displace' a well-established area of state law, for the simple reason that there is no state law regarding the rights of secured creditors in reorganizations.") (Smith, J., dissenting) (quoting *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994) (emphasis added)).

¹⁷⁸ Generally, junior secured creditors cannot foreclose upon the security interests of senior secured creditors. See David Gray Carlson, *Death and Subordination Under Article 9 of the Uniform Commercial Code: Senior Buyers and Senior Lien Creditors*, 5 CARDOZO L. REV. 547, 565-71 (1984).

¹⁷⁹ Judge Smith errs in claiming that "the Constitution has prevented the states from passing [reorganization] laws for the past 207 years." *Rash*, 90 F.3d at 1069 (Smith, J., dissenting). Reorganizations were routinely accomplished under state law during the nineteenth and early twentieth century, though the power of these proceedings to deal with collateral over the opposition of secured parties is unclear. See generally Paula W. Best, Note, *Corporate Receiverships*

Judge King makes an interesting and more effective argument concerning pre-Code practice. She notes that, when an undersecured creditor wished to prove a claim in bankruptcy for the unsecured deficit, the creditor was expected to liquidate the collateral to determine its value. This was as a matter of presumption; courts had the discretion to perform the valuations themselves.¹⁸⁰ The presumption, at least, points to liquidation value as the pre-Code practice. Meanwhile, the Supreme Court has indicated that, when the Bankruptcy Code is ambiguous, courts should presume that pre-Code practices continue.¹⁸¹

Nevertheless, the entire practice of establishing the rights of undersecured creditors by referring to prepetition practice is questionable because the Bankruptcy Code itself worked an enormous sea change in the law of the undersecured creditor. Given the new ability of trustees to use collateral without paying postpetition interest to an undersecured creditor—which never would have been allowed in ancient times¹⁸²—there is no sense in assuming that Congress intended to perpetuate some tiny corner of pre-Code practice, when the whole point of the Bankruptcy Code was radical pro-debtor reform in this area.¹⁸³

E. *Hypothetical Transaction Costs*

The above sections have suggested that neither § 506(a), its legislative history, nor Supreme Court dicta can settle the question of valuation standards. But courts may already have decided a different question: shall the hypothetical transaction costs a secured party saves because a bankruptcy reorganization plan provides for debtor

and Chapter 11 Reorganizations, 10 CARDOZO L. REV. 285 (1988).

¹⁸⁰ See *Rash*, 90 F.3d. at 1050-51 n.18 (citing Bankruptcy Act of 1898, Pub. L. No. 696, 30 Stat. 544, ch. 541, sec. 57 Ch) (repealed 1978); *Merrill v. National Bank*, 173 U.S. 131, 153 (1899) (White, J., dissenting)); accord *Savloff v. Continental Bank (In re Savloff)*, 4 B.R. 285, 287 (Bankr. E.D. Pa. 1980) (Goldhaber, J.) (describing pre-Code practice).

¹⁸¹ See *Dewsnup v. Timm*, 502 U.S. 410, 417 (1992) (Blackmun, J.).

¹⁸² *Timbers* is a radical break from pre-Code practice, when secured creditors were given postpetition interest as a condition of maintaining the stay against repossession. See *Carlson*, *supra* note 54, at 581-84.

¹⁸³ On the intent of the Bankruptcy Code to radically change the plight of the undersecured creditor, see David Gray Carlson, *Bifurcation of Undersecured Claims in Bankruptcy*, 69 AM. BANKR. L.J. 1 (1996); Carlson, *supra* note 54, at 581-84; Mary Josephine Newborn, *Undersecured Creditors in Bankruptcy*; Dewsnup, Nobelman, and the Decline of Priority, 25 ARIZ. ST. L. J. 547 (1993).

retention be subtracted from the valuation? If so, some courts have maintained that, logically, a liquidation valuation must be assigned the collateral. If not, then a going concern valuation must be assigned.

The transaction costs question turns on the insight that the value of collateral to a *buyer* of it and value to the *seller* are different by virtue of the costs of the transaction.¹⁸⁴ As a matter of price theory, these costs—sales expense and maintenance pending sale—are ultimately borne by the buyer. Either the seller covers them and charges the buyer what the market will bear,¹⁸⁵ or the seller does not cover them and the buyer's demand for the item falls, because the true cost of the item is higher than its stated price.

Price theory, however, concerns the conditions needed to bring production into existence. Expected transaction costs, to the extent the seller bears them, would be part of this marginal cost of production and hence the buyer must pay the expense of these anticipated transaction costs.

But foreclosure sales operate according to a different principle. A foreclosure sale of existing collateral does not concern itself with production going forward. The collateral already exists, and a secured party simply wishes to liquidate the collateral to pay an antecedent debt. An oversecured creditor may be able to impose transaction costs upon the debtor.¹⁸⁶ An undersecured creditor who is forced to foreclose, however, cannot get blood from foreclosing on a stone. Rather, the undersecured creditor must bear the cost of the transaction.¹⁸⁷

¹⁸⁴ See *In re Freudenheim*, 189 B.R. 279, 281-82 (Bankr. W.D.N.Y. 1995) (Kaplan, J.).

¹⁸⁵ In a competitive market, the buyer must cover all transaction costs imposed upon the seller. Otherwise, price falls below the marginal cost of production. In a monopolistic market, the buyer and the seller split the burden of transaction costs. As the demand curve becomes more and more elastic, the seller bears a proportionately larger share of the transaction costs.

¹⁸⁶ See U.C.C. § 9-504(1)(a) (1996).

¹⁸⁷ See *Taffi v. United States* (*In re Taffi*), 68 F.3d 306, 312 (9th Cir. 1995) (Kozinski, J., dissenting), *aff'd en banc*, 96 F.3d 1190 (9th Cir. 1996). In *Huntington National Bank v. Pees* (*In re McClurkin*), 31 F.3d 401 (6th Cir. 1994), Judge Richard Suhrheinrich denied that an undersecured creditor bears the transaction costs:

The automatic deduction for "costs of sale" [proceeds] from the erroneous assumption that a secured creditor "receives" only the net proceeds from the disposition of the collateral. When a creditor forecloses on the property . . . the creditor "receives" *all* of the proceeds of the sale. . . . There is no basis . . . for assuming that the costs of sale are paid with the "first dollar" of the sale proceeds rather than being added to the debtor's deficiency.

Id. at 404-05 (citation omitted). It may be true that hypothetical sales costs have the effect of

In deciding whether to deduct hypothetical transaction costs from the value of collateral, courts have once again felt it necessary to determine which of § 506(a)'s two sentences dominates its fellow.¹⁸⁸ Thus, a great many courts have held that the first sentence predominates over the second. The first sentence supposedly commands a liquidation scenario. In a liquidation scenario, the value of the collateral as measured by the price a buyer would pay must be reduced by the costs of the transaction.¹⁸⁹ In contrast, many other courts have read the second sentence of § 506(a)—with its emphasis on debtor use—as implying that where the collateral will not be sold in a reorganization, the value of the collateral should not be lowered by the hypothetical costs of sale.¹⁹⁰ Unfortunately, § 506(a) is no more suited to govern the deduction of hypothetical transaction costs than it was to govern the valuation standard.¹⁹¹

increasing the unsecured deficit, but Suhrheinrich overlooks the fact that positive transaction costs reduce the amount of dollars the secured party obtains *from the collateral*. His point about the size of the deficit has no bearing on the value of the collateral.

¹⁸⁸ See, e.g., *Wolk v. Goldome Realty Credit Corp.* (*In re* 222 Liberty Assocs.), 105 B.R. 798, 803 (Bankr. E.D. Pa. 1989) (Scholl, J.) (finding "tension between the first sentence and the second sentence"); *In re* Claeys, 81 B.R. 985, 990-91 (Bankr. D.N.D. 1987) (Hill, J.) ("Whether a valuation is made without regard for potential costs of liquidation depends, it seems, upon the emphasis given to the first and second sentences . . .").

¹⁸⁹ See, e.g., *In re* 203 N. LaSalle St. Ltd., 190 B.R. 567, 577-79 (Bankr. N.D. Ill. 1995) (Wedoff, J.); *Butters v. Mountain Side Holdings, Inc.* (*In re* Mountain Side Holdings, Inc.), 142 B.R. 421, 423 (D. Colo. 1992) (Kane, J.); *In re* Montgomery Apts., Ltd., 141 B.R. 324, 338-39 (Bankr. S.D. Ohio 1992) (Sellers, J.); *In re* Dixon, 140 B.R. 945 (Bankr. W.D.N.Y. 1992) (Kaplan, J.); *In re* Weber, 140 B.R. 707 (Bankr. S.D. Ohio 1992) (Sellers, J.); *United States v. Coby* (*In re* Coby), 126 B.R. 593, 596 (D. Nev. 1991) (Pro, J.); *Overholt v. Farm Credit Servs.* (*In re* Overholt), 125 B.R. 202, 215 (S.D. Ohio 1990) (Kinneary, J.); *In re* Robbins, 119 B.R. 1, 4 (Bankr. D. Mass. 1990) (Queenan, J.); *In re* Simons, 113 B.R. 942, 948 (Bankr. W.D. Tex. 1990) (Monroe, J.); *In re* Boring, 91 B.R. 791, 795 (Bankr. S.D. Ohio 1989) (Cole, J.) (citing and dismissing contrary authority); *In re* Claeys, 81 B.R. 985, 992 (Bankr. D.N.D. 1987) (Hill, J.); *Greives v. Bank of W. Ind.* (*In re* Greives), 81 B.R. 912, 963-64 (Bankr. N.D. Ind. 1987) (Lindquist, J.); see also *New Haven Inclusion Cases*, 399 U.S. 392, 437 (1970) (Stewart, J.) (deducting hypothetical transaction costs in a pre-Code case).

¹⁹⁰ See, e.g., *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Savs.* (*In re* Winthrop Old Farm Nurseries, Inc.), 50 F.3d 72, 74 (1st Cir. 1995) (Stahl, J.); *Huntington Nat'l Bank v. Pees* (*In re* McClurkin), 31 F.3d 401, 404 (6th Cir. 1994) (Suhrheinrich, J.); *Associates Commercial Corp. v. Rash* (*In re* Rash), 31 F.3d at 329 (5th Cir. 1994) *modified*, 62 F.3d 685 (5th Cir. 1995), *rev'd en banc*, 90 F.3d 1036 (5th Cir. 1996); *Brown & Co. Secs. Corp. v. Balbus* (*In re* Balbus), 933 F.2d 246, 252 (4th Cir. 1991) (Ervin, J.); *In re* Freudenheim, 189 B.R. 279, 281 (Bankr. W.D.N.Y. 1995); *Wolk v. Goldome Realty Credit Corp.* (*In re* 222 Liberty Assocs.), 105 B.R. 798, 803 (Bankr. E.D. Pa. 1989) (Scholl, J.).

¹⁹¹ A compromise between the above two positions—hypothesize a sale versus ignore the sale in reorganization cases—can be found in a view that hypothesizes a sale whenever the collateral is *incidental* to the reorganization. See *In re* Coby, 109 B.R. 963, 965 (Bankr. D. Nev. 1990) (Riegler, J.), *aff'd in part and rev'd in part*, 126 B.R. 593 (D. Nev. 1991).

Debtors have turned to other ideas from the Bankruptcy Code to determine whether hypothetical transaction costs should be deducted from value. For example, debtors have argued that the deduction of hypothetical transaction costs is supported by §506(c) of the Bankruptcy Code, which provides that if sales or maintenance expenses are actually incurred, the trustee may recover those costs from the collateral.¹⁹² More precisely, § 506(c) makes the secured creditor responsible for *actual* transaction costs if the trustee sells the collateral.¹⁹³ Therefore, valuation ought to reflect this hypothetical possibility. This simple point is denied by some courts.¹⁹⁴

Lower courts are fond of squeezing the dregs of Supreme Court opinions and reading the residual tea leaves extracted therefrom. Thus, *United Savings Ass'n v. Timbers of Inwood Forest Associates, Ltd.*,¹⁹⁵ can be read to oppose subjunctive valuations entirely, because the opinion emphasizes the irrelevance of foreclosure.¹⁹⁶ Hence, according to some courts, *Timbers* means that hypothetical transaction costs should not be deducted.¹⁹⁷ But another Supreme Court opinion can be read to insist upon the subjunctive exercise—especially as it pertains to the question of hypothetical transaction costs. In *United States v. Ron Pair Enterprises, Inc.*,¹⁹⁸ Justice Harry Blackmun wrote, "[t]hus, if a \$50,000 claim were secured by a lien on property having a value of \$75,000, the claim would be oversecured *provided* the trustee's costs of preserving or disposing of the property were less than \$25,000."¹⁹⁹ Therefore, it must be con-

¹⁹² See 11 U.S.C. § 506(c) (1994).

¹⁹³ See *id.*

¹⁹⁴ See *Taffi v. United States (In re Taffi)*, 68 F.3d 306, 309-10 (9th Cir. 1995) (Wallace, J.), *aff'd en banc*, 96 F.3d 1190 (9th Cir. 1996); *Huntington National Bank*, 31 F.3d at 405; *Beacon Hill Apts., Ltd. v. Columbia Savs. & Loan Ass'n (In re Beacon Hill Apts., Ltd.)*, 118 B.R. 148, 150-52 (N.D. Ga. 1990) (Evans, J.).

¹⁹⁵ 484 U.S. 365 (1988).

¹⁹⁶ In that case, Justice Scalia remarked, "[t]he phrase 'value of such creditor's interest' in § 506(a) means 'the value of the collateral.'" *Id.* at 372 (quoting 11 U.S.C. § 506(a); H.R. Rep. No. 95-595, 181, 356 (1978)). This remark occurs in the course of interpreting what the identical words in 11 U.S.C. § 361 mean. By emphasizing that § 506(a) requires the valuation of *the collateral*, he argued that the value of the *secured claim* is excluded from the meaning of the phrase. Hence, he ruled, undersecured creditors do not deserve interest compensation for their secured claims. See *Timbers*, 484 U.S. at 381.

¹⁹⁷ *Huntington Nat'l Bank v. Pees (In re McClurkin)*, 31 F.3d 401, 404 (6th Cir. 1994); *Brown & Co. Secs. Corp. v. Balbus (In re Balbus)*, 933 F.2d 246, 250-51 (4th Cir. 1991) (Ervin, J.); but see *In re Chateaugay Corp.*, 154 B.R. 29, 33 (Bankr. S.D.N.Y. 1993) (Lifland, J.) ("the phrases 'such value' and 'value of such creditor's interest in the estate's interest in such property' instructs a court *what* to value but not *how* to value it").

¹⁹⁸ 489 U.S. 235 (1989).

¹⁹⁹ *Id.* at 1029 (emphasis added). Judge Richard Suhrheinrich draws the opposite conclu-

cluded that the dicta of Supreme Court opinions are not conclusive on the question of deducting hypothetical transaction costs.

Suppose a court has a firm rule on hypothetical transaction costs. Does such a ruling commit a court to a specific valuation standard? Since both the transaction costs question and the valuation standard have entailed the technique of privileging one sentence in § 506(a) over the other, it is possible to perceive an affinity between the two questions. Yet in *Rash*, Judge King rejected the claim that decisions on transaction costs had a logical relationship to the question of whether going concern (or replacement) value should be chosen. Instead, she implied, the transaction cost question could be viewed as separate from the question of the appropriate valuation standard.²⁰⁰

In contrast, Judge Smith, dissenting in *Rash*, thought that replacement value "loosely" equated with retail value, and that the difference between retail and wholesale value is precisely the transaction costs of selling at retail.²⁰¹ Hence, a decision for replace-

sion from *Ron Pair*. *Huntington Nat'l Bank*, 31 F.3d at 404. His quote of choice: "[t]hus, a \$100,000 claim, secured by a lien on property of a value of \$60,000, is considered to be a secured claim to the extent of \$60,000, and to be an unsecured claim for \$40,000." *Id.* at 404 (quoting *Ron Pair* 489 U.S. at 240 n.3). This quote, however, fails to indicate whether the \$60,000 was before or after transaction costs were taken into account. In the quote pertaining to *oversecured* creditors, however, Justice Blackmun clearly indicates that the state of oversecurity requires that the deduction for transaction costs not be too large. *See Ron Pair*, 489 U.S. at 1029.

²⁰⁰ Judge King's remarks occur in the course of disagreeing with the dissent as to how many other circuit courts of appeal had chosen replacement value over wholesale value. Four of the cases cited by the dissent were transaction cost cases:

First we note that four of these cases . . . concern only the issue of whether § 506(a) requires a court to deduct the creditor's (or debtor's) hypothetical foreclosure and disposition costs from the otherwise undisputed value of real property securing a loan. By contrast, the deductibility of . . . foreclosure and disposition costs is *not* an issue in this case—there is no evidence related to these costs—and the value of the collateral is otherwise in dispute. As such, these four cases do not address the primary issue in this case, which is whether § 506(a) compels a replacement cost valuation when the debtor proposes to retain the collateral.

Associates Commercial Corp. v. Rash (*In re Rash*), 90 F.3d 1036, 1060 (5th Cir. 1996) (*en banc*); *see also Taffi v. United States* (*In re Taffi*), 68 F.3d 306, 309-10 (9th Cir. 1995) (Wallace, J.) (denying that wholesale value equates with deduction of transaction costs), *aff'd en banc*, 96 F.3d 1190 (9th Cir. 1996). As a member of the original panel in *Taffi*, Judge Alex Kozinski, in dissent, insisted that wholesale valuation does indeed imply that the cost of sale must be deducted, while a retail (or going concern) value implies no deduction of transaction costs. *See id.* at 312.

²⁰¹ Smith wrote:

ment—if only “loosely”—commits a court to the view that transaction costs should not be deducted.²⁰²

At stake in the Fifth Circuit was counting how many other circuit court opinions lined up with the respective positions of the majority and minority opinions. Thus, Judge Smith in dissent counted five other circuit courts on the replacement side of the barricade.²⁰³ Judge King could count only three.²⁰⁴ The difference was whether opinions preventing deduction of transaction costs also counted as decisions for going concern valuations.²⁰⁵

The better view is that the valuation standard and the hypothetical transaction costs question are not the same question. This is so because *both* the replacement standard and the liquidation standard require a rule one way or the other on transaction costs.

If a court looks to a liquidation standard, it is conceivable but not required to imagine that the secured party would have to dissipate the proceeds from a foreclosure sale on vexatious transaction costs, thereby reducing the amount realized to the secured party. But likewise, a court could imagine that the debtor and the secured party will agree to forego the costly foreclosure sale and split the savings between them.²⁰⁶ On this view, some percentage of the hy-

In general, replacement cost equals an asset's retail price, and foreclosure value equals its wholesale price, which is equivalent to the retail price less hypothetical costs of sale. There are, however, instances in which an individual debtor could acquire replacement property for less than retail, or a creditor could resell property for greater than wholesale. Thus, the terms “retail” and “wholesale” value only loosely describe the replacement and foreclosure approaches.

Rash, 90 F.3d at 1062 n.1; see also *Associates Commercial Corp. v. Rash* (*In re Rash*), 62 F.3d 685, 685-87 (5th Cir. 1995) (Smith, J.), *rev'd en banc*, 90 F.3d 1036 (5th Cir. 1996); *In re Coates*, 180 B.R. 110, 116 (Bankr. D.S.C. 1995) (Waites, J.) (claiming this connection); *In re Myers*, 178 B.R. 518, 522 (Bankr. W.D. Okla. 1995) (Lindsey, J.) (same).

²⁰² See *Winthrop Old Farm Nurseries, Inc. v. New Bedford Inst. for Sav.* (*In re Winthrop Old Farm Nurseries, Inc.*), 50 F.3d 72, 74 (1st Cir. 1995) (Stahl, J.) (implying the connection); *In re Weber*, 140 B.R. 707, 711 (Bankr. S.D. Ohio 1992) (Sellers, J.) (claiming that this argument commits a judge to liquidation value generally in reorganization cases); *In re Courtright*, 57 B.R. 495, 497 (Bankr. D. Ore. 1986) (Hess, J.) (same).

²⁰³ See *Rash*, 90 F.3d at 1063 (Smith, J., dissenting).

²⁰⁴ See *Rash*, 90 F.3d at 1060. Of these three, the First Circuit is in doubt, because two recent opinions have taken opposite positions. See *supra* note 11.

²⁰⁵ The disputed opinions about transaction costs (all holding that they should not be deducted in reorganization cases) are *Huntington National Bank v. Pees* (*In re McClurkin*), 31 F.3d 401, 404 (6th Cir. 1994) (Suhrheinrich, J.); *Lomas Mortgage USA v. Wiese* (*In re Wiese*), 980 F.2d 1279, 1283 (9th Cir. 1992) (Nelson, J.), *vacated on other grounds*, 508 U.S. 958 (1993); *Coker v. Sovran Equity Mortgage Corp.* (*In re Coker*), 973 F.2d 258, 260 (4th Cir. 1992) (Hall, J.); *Brown & Co. Secs. Corp. v. Balbus* (*In re Balbus*), 933 F.2d 246, 248-49 (4th Cir. 1991) (Ervin, J.).

²⁰⁶ See David Gray Carlson, *Debt Collection as Rent Seeking*, 79 MINN. L. REV. 817, 844-49 (1995) (rational creditors and debtor would cut out sheriff by side agreements).

pothetical transaction costs could be deducted—or none at all.

If a court looks to the “replacement” value of collateral—what the debtor would pay to prevent foreclosure and loss of going concern value—a sale is nevertheless hypothesized. The debtor is imagined to enter the marketplace to find the exact same kind of collateral to cover for the repossession of that which hypothetically occurs. Yet, as has been emphasized,²⁰⁷ courts following the replacement value standard might well conclude that the value of the replacement should be based upon complete homogeneity of replaced and replacing items. The hypothetical seller of the replacing item is offering an extra unneeded service—the transaction itself—which is not homogenous with the replaced item. Just as a warranty should be removed from the value of the item, so should the “transaction” aspect of the product be removed, in the name of homogeneity. If this is done, deduction of transaction costs occurs even if replacement value is chosen. Alternatively, a court could make no deduction, in which case the secured party exploits the debtor’s inability to find a completely homogeneous replacement. Thus, a court’s position on deducting hypothetical transaction costs is *not* the same question as whether liquidation or going concern valuations should prevail.

F. *Two Arguments for Liquidation Value*

Heretofore, the arguments for or against going concern valuations in reorganization cases have been found to be indeterminate. What follows are two arguments that point toward liquidation values. These arguments are sufficient to settle the question, not only in chapter 13 cases, but in chapter 11 cases as well.

1. *Implications of “Best Interest of the Creditors Test”*

According to the Supreme Court, the Bankruptcy Code should be read in a “holistic” fashion.²⁰⁸ Therefore it is promising to read some other sections of the Bankruptcy Code besides § 506(a) to see if any hints can be gleaned about the proper valuation standard in bankruptcy reorganization cases.

²⁰⁷ See generally *supra* section II.C.

²⁰⁸ See *United Savs. Ass’n v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 371 (1988) (Scalia, J.)

In choosing between going concern or liquidation value, we have seen that, through the power of association, many courts use liquidation value in liquidation cases and going concern value in reorganizations.²⁰⁹ There is an interesting doctrinal argument in favor of *liquidation* value in reorganization cases, however.

This argument uses the so-called "best interests of the creditors" rule, under which every dissenting creditor is entitled to get the same amount or more from the plan as she would have gotten in a hypothetical liquidation.²¹⁰ Such a rule guarantees that everyone is either unaffected or is better off with a going concern than with a liquidation. This test implies that a bankruptcy court must value unencumbered assets of the bankruptcy estate according to a liquidation standard.²¹¹ Since chapters 11 and 13 each require that the secured party get no less than she would have gotten in a chapter 7 liquidation, it might seem appropriate that the secured party's collateral be given its liquidation value as well. It would certainly count as peculiar that, in hypothesizing what a liquidation would have brought in, a court would value the collateral as if the firm were a going concern (unless, of course, a liquidation proceeding could itself plausibly produce going concern value).²¹²

In such matters, it is always possible to argue the opposite, and, accordingly, one commentator finds in the "best interests" rule the exact opposite implication from what has been suggested. According to Isaac Pachulski, if the "best interests" test of Bankruptcy Code § 1129(a)(7)(A)(ii) requires a liquidation standard, then the separate "fair and equitable" rule of cram down²¹³ must require something else. Otherwise, it is entirely redundant, and Congress is presumed *never* to act inefficaciously.²¹⁴

²⁰⁹ See *supra* text accompanying notes 103-04.

²¹⁰ See 11 U.S.C. §§ 1129(a)(7)(A)(ii), 1325(a)(4) (1994).

²¹¹ For a case finding retail when no security interest existed on the car, see *In re Gallup*, 194 B.R. 851 (Bankr. W.D. Mo. 1996) (Koger, J.). This case is wrongly decided, in that § 1325(a)(4) refers to a liquidation standard.

²¹² *In re Robbins*, 119 B.R. 1, 3 (Bankr. D. Mass. 1990) (Queenan, J.) (implying that liquidation is mandated by § 1129(a)(7)); *In re Jumpers Equities, Ltd.*, 4 Bankr. Ct. Dec. (CRR) 1269, 1270 (Bankr. D. Md. 1978) (Thomsen, J.) (liquidation value is the constitutional minimum that secured parties must get; going concern value is just a bonus). This last statement, however, is bad constitutional law; the Bankruptcy Code need not give *anything* to secured parties, if it doesn't feel like it, although *perhaps* an argument can be made against *retrospective* application of bankruptcy legislation. See Carlson, *supra* note 54, at 585-89.

²¹³ See 11 U.S.C. § 1129(b)(1) (1994).

²¹⁴ See Isaac Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*,

The problem with arguments from the necessity of statutory language is that they are defeated if one can assign some necessity to the statutory provision that is accused of redundancy. For example, the cram down provision is not redundant because it serves to rule out the possibility that secured parties be given equity securities for their collateral.²¹⁵ By virtue of this demonstration of utility, it is now possible to use liquidation for both the "best interests" rule and the "fair and equitable" rule. Indeed, the sudden shifting of valuation standards in the middle of the bankruptcy proceeding is called "bizarre" by none other than Pachulski himself (although he nevertheless defends it).²¹⁶ The discovery of cram down's utility in the face of liquidation value prevents such an inexplicable shift of valuation standards.

2. Cram Down

It has been suggested that a liquidation value is appropriate in chapter 13 cases, at least, because the consequences of a debtor's cram down options should be precisely equal. This argument was first presented by Judge Robert Parker in his dissenting opinion to the earlier panel decision in *Associates Commercial Corp. v. Rash* (*In re Rash*).²¹⁷ In the *en banc* opinion, Judge King gave prominence to the idea.²¹⁸

King noted that, under § 1325(a)(5), a debtor might cram down a secured creditor by one of two means—(1) retaining the collateral and paying the "value" of the collateral over time, and (2) abandoning the collateral, so that it could be liquidated in a foreclosure sale. Of these two methods, King writes:

Structurally, it appears that these two alternatives are set forth as equivalent methods of protecting the creditor's security interest where it does not accept the debtor's treatment of that interest under the plan. Accordingly, one would expect that these alternatives would

58 N.C. L. REV. 925, 958-59 (1980).

²¹⁵ See *id.* at 949-50.

²¹⁶ *Id.* at 965.

²¹⁷ 62 F.3d 685, 687-88 (5th Cir. 1995) (Parker, J., dissenting), *rev'd*, 90 F.3d 1036 (5th Cir. 1996) (*en banc*).

²¹⁸ See *Associates Commercial Corp. v. Rash* (*In re Rash*) 90 F.3d 1036, 1045-47 (5th Cir. 1996) (*en banc*).

yield the same result.²¹⁹

Thus, because abandonment results in a liquidation value for the secured creditor, so should retention. Hence, retention by the debtor implies a liquidation value.

This argument seems to be based on the idea that the debtor is to have managerial freedom over the estate, but the choice must not harm the secured party. Hence, the two options are to be equal in terms of value.²²⁰

This argument has an irony. The argument states that the debtor must render the secured creditor indifferent between cram down options, so that the debtor will not be able to take value from that creditor by choosing one option over another. Yet the argument is presented precisely to deprive the secured creditor of going concern valuations in reorganization cases. Nevertheless, the irony is only apparent. At stake is the intent of Congress. The presentation of the two cram down options is a strong hint that Congress intended abandonment and retention to be economically identical from the standpoint of the secured creditor. Since abandonment is consistent with liquidation value (because that is what would happen once the abandonment occurred), retention should likewise be based on liquidation value.²²¹

²¹⁹ *Id.* at 1046.

²²⁰ In dissent, Judge Smith complains that, empirically, most chapter 13 plans fail before they are completed. *See id.* at 1063 n.6 (citing William C. Whitford, *The Ideal of Individualized Justice*, 68 AM. BANKR. L.J. 397, 410-11 (1994)). Thus, the secured party is not symmetrically treated between 11 U.S.C. § 1325(a)(5)(A) and (B). This is not a good objection. Going forward, a chapter 13 plan is confirmed because the court thinks the plan will be completed. *See* 11 U.S.C. § 1325(a)(6) (1994) (plan confirmable only if "the debtor will be able to make all payments under the plan and to comply with the plan"). That plans fail empirically, contrary to this instruction, is an embarrassment to the judicial administration of the chapter 13, but it does not defeat Judge King's argument as to what Congress intended in enacting § 506(a) and § 1325(a)(5), taken together. Congress may have intended that plans *not* fail, and that the two options treat the secured party in an equivalent manner.

²²¹ One similar argument for wholesale value is drawn from the "coerced loan" theory of determining the proper cram down interest rate. In *General Motors Acceptance Corp. v. Jones*, 999 F.2d 63 (3d Cir. 1993), Judge Walter Stapleton had ruled that cram down interest rates should equate with the rate which regional lenders of similar loans would charge persons similarly situated to the debtor on the open market, absent of bankruptcy." *Id.* at 69-70. Stapleton continued that this interest rate was designed to put the creditor "in approximately the same position it would have occupied had it been able simply to repossess the collateral at the time of the bankruptcy." *Id.* at 68. In *In re Maddox*, 194 B.R. 762, 767 (Bankr. D.N.J.), *aff'd*, 200 B.R. 546 (D.N.J. 1996), Judge Judith Wizmur took this remark to indicate that a hypothetical liquidation sale had to be imagined, which equated with wholesale value. *See id.* at 770. This opin-

IV. CONCLUSION

The Courts of Appeal are sorely divided on the question of valuation in chapter 13 cases. At stake are cars encumbered by security interests. Cars have an easily accessible wholesale value and a higher retail value. The trend seems to favor the higher retail value, which promises to make chapter 13 more expensive for debtors. Nevertheless, both valuation theory and a holistic reading of the Bankruptcy Code have shown that liquidation value is the proper choice—not just in chapter 13 but in chapters 11 and 12 as well.

Valuation theory teaches that the distinction between wholesale and retail value is false. Retail prices reflect value added by the retailer. The cost of these add-ons should be removed from value, so that the item a debtor would hypothetically replace existing collateral with is precisely homogeneous with the actual piece of collateral the debtor is to retain. If this is done, retail value reverts to wholesale value.

Furthermore, the legislative history prohibits crude rule making by the courts. Appellate courts should not declare either wholesale or retail values to be correct. Rather, these courts should grant the lower courts discretion to find value. If this is done, valuation technique will work to dissolve retail value into wholesale value.

Beyond the lessons of valuation theory, a holistic reading of the Bankruptcy Code points toward liquidation value. This is so because of two different provisions in the Code. One of these provisions is the "best interest of the creditors" test, that applies to unsecured creditors in chapter 13.²²² Since this provision points to liquidation value of a debtor's unencumbered assets, it is natural to assume that Congress intended to extend the same valuation standard to encumbered assets. The second provision is cram down of secured creditors, where the debtor is invited to choose between abandoning the collateral or retaining it and giving instead payments with a present value equal to that of the collateral.²²³ It is reasonable to assume that cram down is designed to render the secured creditor indifferent between these two options. Whatever the debtor does, the

ion seems to reflect the notion that cram down options ought to be equal, and that abandoning the collateral implies a liquidation value, for most secured creditors.

²²² See 11 U.S.C. § 1325(a)(4) (1994).

²²³ See 11 U.S.C. § 1325(a)(5) (1994).

debtor's choice should export no cost to the secured creditor. Since abandonment implies that the secured party will realize a liquidation value of the collateral, retention of the collateral for cram down purposes should likewise entail the same liquidation standard.